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102d Congress
1st Session

JOINT COMMITTEE PRINT

S. PRT.
102-30

POSTWAR ECONOMIC RECOVERY IN THE PERSIAN GULF

PROCEEDINGS

OF A

WORKSHOP

ON

MARCH 28, 1991

SPONSORED JOINTLY BY THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

AND THE

CONGRESSIONAL RESEARCH SERVICE
LIBRARY OF CONGRESS

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
44-430
WASHINGTON : 1991

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, DC 20402

J842-13

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LETTER OF TRANSMITTAL

JULY 10, 1991.

To the Members of the Joint Economic Committee:

I am pleased to transmit to you the proceedings of a workshop on postwar economic issues in the Persian Gulf. The workshop, which was held on March 28, 1991, was cosponsored by the Joint Economic Committee and the Congressional Research Service.

The purpose of this workshop was to examine the effects of the war on the economies of the countries of the region and the issues involved in recovery and reconstruction. The Joint Economic Committee would like to thank the participants, who were chosen for their expertise and represented a wide range of disciplines and backgrounds.

The workshop was planned and directed by Jim Wooten, Specialist in Foreign Affairs, Congressional Research Service, and Richard F Kaufman, General Counsel of the Joint Economic Committee. We are grateful to the Congressional Research Service for making Jim Wooten and others available to work on the project, and to the participants. There is a longstanding tradition of cordial and productive cooperation between the Committee and the CRS, and the workshop contributed significantly to that tradition.

The views expressed in the proceedings are those of the participants and not necessarily those of the Joint Economic Committee or its individual members.

Sincerely,

PAUL S. SARBANES,
Chairman.

INTRODUCTION

By Paul S. Sarbanes, Chairman

As national attention shifts from the military successes achieved by coalition forces in the Persian Gulf to the war's longer term political and social consequences, the need is growing for detailed information and careful analysis of the economics of the region after the war.

There are not only the immediate costs of repairing physical destruction and rebuilding regional infrastructure to consider, but also environmental damage, demographic changes, new trade patterns, and the direct and indirect effects of disruption in oil supply, for both producers and consumers. Clearly, the economic effects of the war will not be as limited in time or in area as were the military operations.

In order to address these questions, the Joint Economic Committee, in conjunction with the Congressional Research Service, organized a workshop on March 28, 1991, to examine the prospects for postwar economic recovery in the Persian Gulf. Participants in the workshop, chosen for their expertise in the region, were divided into three panels. The first panel discussed the economic situation in the Persian Gulf region prior to the war; the second dealt with the economic costs and consequences of the war; and the third panel addressed the possibilities for recovery and reconstruction.

Although differences of opinion were expressed on several matters, a broad consensus emerged in the key areas of analysis: the economies of the Middle East were weak and deteriorating before Iraq invaded Kuwait; the military conflict made the economic and political problems of the region much worse; the governments of the Persian Gulf nations are far less likely to engage in economic reform in the postwar period; and, because regional security is critical to economic reconstruction, the United States should play a responsible role in securing a sustainable regional security arrangement.

A summary of the proceedings of the Joint Economic Committee and Congressional Research Service Workshop on Postwar Economic Recovery in the Persian Gulf follows.

EXECUTIVE SUMMARY

By Richard F Kaufman [*]

1. The Economies of the Middle East Were Weak and Deteriorating Before Iraq Invaded Kuwait

The economies of the Persian Gulf region were weak before Iraq's invasion of Kuwait. Although official statistics are incomplete and often misleading, it is generally acknowledged that the region as a whole is among the poorest in the world, that a slowdown in growth rates was in progress before the invasion, and that the prospects would be bleak had there been no crisis.

Estimates prepared by Yahya Sadowski, Research Associate, Foreign Policy Studies Program, The Brookings Institution, and the Joint Economic Committee staff, submitted to the workshop in a series of tables, indicate the low levels of economic performance at the time of the invasion. The per capita gross domestic product for most countries was in the $2,000–$3,000 range, and for the regional population as a whole it was about $1,600 in 1989. Life expectancy and literacy rates were relatively low. Annual inflation ranged from 20 percent to 80 percent, except for Saudi Arabia and Kuwait. In several countries, unemployment rates were in double digits.

In the summer of 1990, economic conditions in the region were deteriorating further, partly as a result of the decline in world oil prices and reduced hard currency earnings by the oil producing states and of the effects of the war between Iraq and Iran.

The international positions of most of the economies were also precarious. Some of the world's most highly indebted nations were, and still are, in the Middle East. Arab aid to Arab states fell sharply in the 1980's and the need for aid in Eastern Europe and other areas of the world was straining the abilities of industrialized countries to provide resources for the Middle East.

2. The Military Conflict Made the Economic and Political Problems of the Region Much Worse

The region is much poorer than it was last year, and the inequalities among the Arab states were greatly aggravated, by the war.

Participants in the workshop placed estimates of the economic effects of the war in the $300 billion to $500 billion range. Such estimates are uncertain, but they underline the magnitude of the damages and the tasks that must be undertaken just to repair them. The estimates include: the destruction of the physical infrastructure, disruptions of energy supplies and trade generally, lost remittances from foreign workers expelled from Kuwait and other countries, costs of resettling displaced workers and their families, the people and military equipment consumed by the war, lost tourism, increased energy costs due to the price rises during the crisis, and environmental losses from oil spills in the Gulf and fires in Kuwait.

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[*] General Counsel, Joint Economic Committee.

Melinda Kimble, Country Director for Egypt, Bureau of Near Eastern and South Asian Affairs, Department of State, presented a number of specific estimates: United Nations sanctions reduced Jordan's GNP by half. The costs of rebuilding Kuwait's infrastructure could be $40 billion to $100 billion; lost income from the fires amounts to $87 million per day or $30 billion yearly. The states that export labor will lose remittances from workers of approximately $3 billion through the end of 1991, a loss that could result in economic retrenchment in the countries most dependent on them—Egypt, Jordan, and Yemen. The costs of cleaning up the Gulf oil spills could be three times the clean up of the Exxon Valdez, or $9 billion. Participants in the symposium said that the Gulf countries are unlikely to mount the required cleanup effort, leading to collateral damages other industries, such as fishing.

The effects of the war on Kuwait and Iraq alone will be equivalent to a 15 percent contraction of total Arab per capita GDP. The possibility of an accelerating regional downturn cannot be ruled out.

The global consequences of the oil disruptions during the war were discussed by John Lichtblau, Chairman and Chief Executive Officer, Petroleum Industry Research Foundation, Inc., New York. He said it was fortunate that, as early as September 1990, the loss of oil from Iraq and Kuwait was offset by increased production elsewhere. Lichtblau projected that world demand for oil would decline slightly in 1991, because of the recession in the United States and depressed conditions in the Soviet Union and Eastern Europe. As a result, world oil production capacity and output will be approximately in balance and prices should not rise sharply.

Lichtblau cautioned that there is no spare capacity until Iraq and Kuwait come back on stream, so that a new crisis could occur if there is a new interruption of supplies. For example, production in the Soviet Union has been declining. A precipitous decline in oil production in that country could not now be offset by increased production elsewhere.

Lichtblau also noted that U.S. dependence on foreign oil is increasing, and that Middle East oil will become even more important in the global economy over the next 10 years.

3. The Governments of the Persian Gulf Nations Are Far Less Likely To Engage in Economic Reform in the Post-War Period

Participants suggested that, because the economic problems facing the Arab states have been greatly aggravated by the war, their governments are far less likely to attempt reforms that might possibly have an adverse short-term impact on their people's standard of living. While they agreed that economic reform is essential for future growth and more equitable distribution of income in the region, they had differing views on how and whether these goals might be attained.

The governments in the Middle East dominate their economies to an extent similar to that of the Soviet Union and Eastern Europe. Hani Findakly, President, Potomac Capital, Inc., New York, stated that the public sectors dominate economic output and financial flows, and regulate the formation and activities of private enterprises in a manner that inhibits private development and economic growth. Most industries are government owned, and with the exception of small stock exchanges in a few countries, there is no broad ownership of major corporations.

The benefits of the oil sector in the oil-producing countries trickle down very slowly into the private sector where existing companies are protected against new entries and foreign competition. Kuwait, for example, forbids equity ownership by nonresidents. In the 1970's, Saudi Arabia forced foreigners to sell at least 51 percent of their holdings to local investors.

Other attributes common to the region will influence efforts to promote recovery and sustained growth. Mismanagement of fiscal and monetary policies—including excessive military spending—and the maintenance of artificially low interest rates have discouraged savings and encouraged speculative investments and capital flight. The value of foreign assets held by Egyptian citizens reportedly amounts to $40 billion, about the same as Egypt's foreign debt. In addition, there is an absence of economic linkages among the Middle East countries. Trade and banking relationships have not been well developed. It is reportedly easier to find Kuwaiti or Saudi banks in London and New York than in Cairo and Istanbul.

Questions were raised about the efficacy of economic aid in the absence of needed structural reform. The international aid community may be able to strengthen economic and financial ties within the region by adopting a regional focus to its efforts. The U.S. role need be only the catalytic one of providing technical assistance. Findakly proposed that the various regional and bilateral agencies of the Middle East be combined into a super aid agency with sufficient borrowing power to coordinate external aid and to link it with liberalization of the economies and growth of the private sectors.

Other participants argued that change in the Middle East is inevitable but will not necessarily be for the better. Richard Feinberg, Executive Vice President and Director of Studies, Overseas Development Council, argued that economic development has not progressed in the Middle East despite the availability of resources in the region. Economic decline can sometimes lead to self-criticism and new policies, and the capital shortage in the Middle East can thus have positive results. Pressures from the Arab populations and the competition from markets abroad will force change. Feinberg agreed that for development to occur there must be reform.

Fareed Mohamedi, Senior Economist, The Petroleum Finance Company, Ltd., made a similar point about the pressures for and desirability of structural reform, but he cautioned that the process of regional disintegration is now intensifying. In light of the decline of bilateral assistance from the Gulf states to the poorer Arab countries, he urged creation of a new aid mechanism in the form of a regional development bank. The bulk of the capital would come from the Gulf countries. With some participation from industrial countries, such a bank could borrow from international capital markets and provide funds to needy countries. He said that a principal advantage of a multilateral development bank is that it could require that funds be used for productive purposes, as opposed to reconstruction of state-owned enterprises and the financing of military programs. Bilateral lenders have been unable to impose such requirements.

Mohamedi said that in the postwar period, the Gulf governments would pursue three major policy objectives to regain economic stability: expansion of hydrocarbon capacity; control of government deficits; and expansion of the nonoil sector. A consequence of these policies would be less government support of the business sector and greater demands by business for a role in economic decision-making. As a result, some business elements will become allied with those factions in the Gulf countries calling for more democracy.

But serious doubts were expressed about the likelihood that any country would actually initiate major economic or political reforms. Sadowski maintained that Arab governments understand the painful price of engaging in reforms and see through the conditionality argument. They know that ultimately the basis for aid is political, not economic.

According to Bernie Reich, Professor, Political Science and International Affairs, Department of Politics, George Washington University, most wars in the Middle East have been seen as watersheds followed by euphoria about the possibilities for dealing with problems of political security and the economic ills. Often the postwar euphoria has led to hasty, unsuccessful actions. Any new initiatives should be designed bearing in mind that economic recovery cannot be separated from political stability, issues of security, the Arab–Israeli conflict, and the arms race. Reich saw little likelihood of democratization or dramatic breakthroughs in any area and recommended a wary approach to proposals that may deflect attention from dealing with the current crisis.

4. Economic Recovery Depends Critically on a Sustainable Regional Security Arrangement, in which the United States Plays a Responsible Role

The critical elements of any regional security arrangement, according to symposium participants, are the participation of all states in the region, and an agreement not to change borders by force. John Steinbruner, Director of Foreign Policy Studies, The Brookings Institution, emphasized the need for an integrated policy that includes economic development and a political program that induces nonviolent interaction among the states of the region. He said that military power must be restricted to the defense of territory already held, backed by an international guaranty. As an incentive, access to international capital markets might be conditioned on such a formalized arrangement.

Steinbruner said that the export of weapons into the region must be controlled. To achieve an effective control regime, the regional powers and major supplier nations, including the Soviet Union and China, will have to cooperate and provide disclosure of their weapons programs. Weapons of mass destruction would be prohibited within the region. Although arms sales to the region would not be absolutely prohibited, their scale would have to be proportionate to the legitimate size of the regional military establishments.

Other participants were in agreement about the importance of limiting arms sales to the Middle East. Fareed S. Mohamedi of the Petroleum Finance Institute observed that arms sales to the region were counterproductive on two levels: they contribute to the heavy defense burdens in the region that help explain the unproductive economies, and they absorb foreign credits which might otherwise be used to expand exports.

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POSTWAR ECONOMIC RECOVERY IN THE PERSIAN GULF

THURSDAY, MARCH 28, 1991

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
JOINTLY WITH THE
CONGRESSIONAL RESEARCH SERVICE,
LIBRARY OF CONGRESS,
Washington, D.C.

The workshop was convened, pursuant to notice, at 9:10 a.m., in room 649, Madison Annex, Library of Congress; Hon. Paul S. Sarbanes, Chairman of the Committee. Richard Kaufman and Jim Wootten were co-moderators. Also present, Joe Ross, Director, Congressional Research Service, Library of Congress.

OPENING STATEMENT OF JOE ROSS, DIRECTOR, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

Mr. Ross. Good morning, ladies and gentlemen. My name is Joe Ross and I am the Director of the Congressional Research Service. It is a privilege for me to welcome you to this seminar on the postwar economic recovery in the Persian Gulf.

My job this morning is to introduce Jim Wootten, a specialist in our Foreign Affairs and National Defense Division at CRS, who is going to moderate the program all day.

As you have seen from the announcement, the program will consist of three panels. The first one this morning has experts both from the Hill and from several of the think-tanks around town. I'll now turn the program over to Jim.

Jim Wootten.

OPENING STATEMENT OF JIM WOOTTEN, SPECIALIST, FOREIGN AFFAIRS AND NATIONAL DEFENSE DIVISION, CONGRESSIONAL RESEARCH SERVICE

Mr. WOOTTEN. Thank you, Joe.

Since August 2, when Iraq invaded Kuwait, the attention of the country and certainly here on Capital Hill has been focused almost entirely on the situation in the Persian Gulf.

Fortunately, most of the pundits were wrong. The War was over quickly and with extraordinarily light casualties on the Coalition side. And we're all thankful for that.

But now comes the difficult task of repairing the damage caused by the War and alleviating the problems that were there before the War. A large part of the task will be the search for economic and political stability in the Gulf, which most experts describe as the mainstay of American foreign policy there.

We have no shortage of suggestions about how to go about these tasks. But anyone familiar with the area knows the difficult and deep-seated economic and political problems that preceded and, as we will point out today, were probably worsened by the War. People also tend to forget just how much the economic and political situations in the Middle East are so intertwined.

Consequently, there is a good deal of conventional wisdom about the economic situation in the Gulf, just as there was about the War. It was for this reason that the Joint Economic Committee asked CRS to put together this workshop and publish the results for the benefit of all those who will be working on Gulf projects in the aftermath of the War. We are particularly proud of the stature of the panelists that we have asked to contribute to our workshop today. I think, as the day goes on, all of you will agree.

I do not expect that all the panelists will agree on the specifics. The value of CRS workshops is that they present a range of ideas from experts. There is a distinct possibility that the panelists will differ among themselves and they will have the opportunity to discuss their differences. We also expect to hear from you, the audience, and this is what distinguishes these workshops from congressional hearings. It's an opportunity for all of you to weigh-in on the subject and ask questions.

We will permit the panelists to complete their prepared remarks and then allow time for discussions among themselves. After this, we will immediately open up for questions from the audience.

Before we begin with the first panel, however, I want to introduce Mr. Richard Kaufman, a long time friend of mine, but also the General Counsel for the Joint Economic Committee. It was Richard who was instrumental in suggesting this project from the beginning and I want to give him a chance to say something before we get to the first panelist.

OPENING STATEMENT OF RICHARD F KAUFMAN, GENERAL COUNSEL, JOINT ECONOMIC COMMITTEE

Mr. **Kaufman**. Just a couple of words before the experts begin. I do want to welcome everybody on behalf of the Joint Economic Committee and its Chairman, Senator Paul Sarbanes, who directed the staff of the Committee to begin thinking about the problems of the postwar period virtually the day after the War began in January. The purpose of this exercise is to begin thinking seriously about postwar recovery and reconstruction in the Middle East. I might add that recovery by itself might not be the ideal outcome to many people who live in the region since, if they got back to where they were before the War, it might not seem such a good deal.

Wars do bring change. The intention here is to examine just what changes might take place and what the possibilities are for new approaches in this region.

With that, I will turn it back to the experts and look forward to hearing their presentations and the dialogue that we hope to stimulate with the audience and among the experts following the presentations.

Mr. WOOTTEN. I have decided to introduce each panelist individually before they make their presentation. That will allow me to describe their credentials more fully and give you an opportunity to recognize exactly what they bring to this panel.

In this first session, we're going to talk primarily about the economic situation in the Persian Gulf area, and how economics contributed to the events leading up to the Iraq invasion and the way the sides lined up as they did. I have asked each of the panelists to talk a little bit into the future and where we might be going during the next decade as far as the economic situation is concerned.

Our first speaker is eminently qualified to do that. He is Yahya Sadowski of The Brookings Institution. Yahya has lived in Beirut, Damascus, and Cairo and travels regularly in the area. He received his doctorate in political science from UCLA in 1984. He has been an assistant professor of Middle Eastern studies and comparative politics at Johns Hopkins University. He joined Brookings as a research associate in 1986 and has written extensively about the political and economic developments in Syria, Egypt and the entire Middle East.

STATEMENT OF YAHYA M. SADOWSKI, RESEARCH ASSOCIATE FOREIGN POLICY STUDIES PROGRAM, THE BROOKINGS INSTITUTION

Mr. SADOWSKI. Can you all hear me and see me?

I should start off with a warning. I do specialize in the politics of economic development in the Middle East and I work on this issue 60 hours a week and have been for the better part of 20 years. And I see it as a very complex, very rich subject, and I get into the details of it.

I just finished writing a 700-page book on the politics of agricultural price reforms in Egypt. This is one of those subjects which requires hours and hours to explain properly. But I have been given 15 minutes to provide a massive overview of the economic background of the Gulf War and some of the raw projections of what it means for the economies of the region in the future.

I don't think I can do it, but I'm going to try by doing two things. First, I'm going to make some fairly broad-based statements up front and then hope that within the 10 minutes or so that remain to me I can fill in the details and make them persuasive.

Second, I'm going to try very quickly to cram in as much as I can along the way. If any of you have problems following me, if what I say is not clear, it's not lucid, it's ambiguous, please feel free to stop me during the presentation rather than waiting for the question and answer session for clarifications.

I think maybe I can make a couple of the points I want to make right up front by giving you all one concrete example in the form of an apocryphal story. This concerns the way Saudi Arabia measures its population. The story goes something like this:

Back in the early 1960's, nobody in Saudi Arabia knew how many people lived in the country. So they contracted a group of American demographers to come in and do the first population survey of Saudi Arabia. These Americans went in, they flew over the desert and took photographs of the numbers of tents. They handed out census forms in the cities trying to find out how many people were in the apartment buildings, and at the end of it they came and reported the results to King Saud and they said, Your Majesty, we have the honor to inform you that the population of the Kingdom of Saudi Arabia is 2 million people. And the king was outraged. He said, 2 million people? That's ridiculous. That makes us barely larger than Kuwait. Here we are, the most esteemed, the most prominent, most important of the Arab monarchies and you are suggesting that we're about the same size in population terms as the lowly Kuwaitis?

The demographers were a little bit taken aback and they said, well, it's true that there is a margin of error in our calculations. It's possible that we undercounted the number of tents or misestimated the number of Bedouins. But it is just conceivable that the population of the Kingdom is 3 million people.

And the king said, that's hopeless, that's ridiculous. Three million people? That might give us an edge on the Kuwaitis, but my goodness, Yemen, right down the road, inhabited by these short, poor, obnoxious people has a population of 8 million people. We can't possibly have a third the population of Yemen.

The demographers said, Your Majesty, we just don't see how it's possible, given your existing resources, that the Kingdom could support more than 4 million people.

The king said, done, 4 million. [Laughter.]

The story is probably not true, but it might as well be. The truth is to this day that the Kingdom of Saudi Arabia routinely issues vastly inflated population figures. I handed out some tables. The Kingdom of Saudi Arabia today lists a population of 14 million people, and I put it down as such here. I don't seriously believe the Saudis have more than about 9 million people.

But the story illustrates two important points that I think you should keep in mind throughout the day's deliberations. First, you are probably going to hear a lot of numbers tossed around today, a lot of economic statistics, data on how wealthy certain countries are and how much economic damage they've suffered, et cetera. Please try to treat all these figures as ballpark figures. For all intents and purposes, there's only three numbers in the Middle Eastern accounting system. There's zero, a few, and many. Anything that claims to be more accurate than such a ballpark reckoning simply can't be relied on.

If you take a look at the table I've given you, I've gone to a great deal of effort to make these numbers as accurate as I can and I think they are accurate in the sense that they identify real problems and real issues.

But if you were to sit down and ask me to make a bet about whether one particular number might change by a value of plus or minus 5 percent over the next year or something like that, I wouldn't take it because I'm not confident that any of these numbers are accurate within plus or minus 20 percent. Be very careful about the numbers.

The second thing that I think the story illustrates is that one of the reasons why the numbers on the Middle East are so unreliable is because economic facts in the Middle East are fraught with political significance. The Saudis understand very well that their population statistics have some bearing on their political stature in the region. As a result, bureaucrats in the Middle East routinely cook up numbers, adjust numbers, fail to report numbers.

If some of you have tried to do any work on Iraq since this crisis broke out, you may have discovered that the Iraqis essentially stopped reporting their national account statistics to the World Bank and the IMF back in 1975, once they got rich enough so that they didn't feel they needed the support of these institutions anymore. They began to treat these numbers as national security secrets. They have been very reluctant to issue hard data ever since.

I have been in the office of an Egyptian bureaucrat when he received a call from the World Bank asking specifically—I think it was something like what number of Egyptian villages have been successfully electrified. What number of Egyptian villages receive electrical power?

Well, I was sitting in the office talking to this guy about agricultural policy. He gets this call from Washington. This is in Cairo. He puts the call on hold and he goes back to talking with me. He talks with me for 5 minutes. At the end of that, he pushes the hold button, picks up the phone and says, 4,253. [Laughter.]

The number was just pulled out of thin air. He had to report a number to the World Bank. He knew that was a number that would look good relative to the total number of Egyptian villages. There was a specific political reason he was doing that number rather than some other one. But it has no hard economic significance whatsoever.

We can use the numbers on the Middle East to draw some very broad, crude lessons about trends and problems in the region. And in the tables that I handed out, I'm trying to draw your attention to some of those lessons. There are a couple in particular that I would like to start out with.

Two things that I don't think are widely enough understood about the Middle East by people in the United States have to do with the relationships between what the press at least tends to call the rich and the poor Arab states. There is some understanding and sensitivity here to the fact that there are vast income disparities among the Arab states.

But I don't think by and large we've focused on what the real character of those disparities are. I, for example, don't even think I can use the vocabulary rich and poor Arab states because the truth of the matter is I don't think there are any rich Arab states.

In the tables I handed out to you, I gave a series of different data. But the rankings of the countries that I gave you are especially important. I divided the Arab states up into three categories: Those with comfortable standards of living, those with tolerable standards of living, and those with miserable standards of living.

And I have done the rankings in accordance with something called the human development index developed by the United Nations Development Program, which does not rank countries the same way most World Bank data does—for example, simply by gross national product per capita—but takes a much broader basket of economic indicators to decide which countries are relatively rich or poor. It includes gross domestic product, purchasing parity power, adjusted literacy rates, longevity rates, numbers of physicians per capita, percentage of the population with access to clean water, et cetera.

When you take all the different states in the Arab world and you rank them according to these criteria, two facts stand out, and these two facts I'm fairly confident of, even though the specific numbers are relatively soft. One of them is that all of the countries in the Arab world are much, much poorer by international standards than we commonly assume.

If you take a look at the first table I handed out on the condition of Arab states with comfortable standards of living, you will notice that there is no country in the Arab world with a standard of living equal to that of Mexico. Essentially the richest countries in the Middle East do not rise up to the standard of middle level Latin American countries. Venezuela has literacy and longevity and health care rates and so on far in excess of what the absolutely richest Gulf sheikdoms have been able to achieve.

In point of fact, the bulk of the Arab population, if you take a look at the third table I handed you on the condition of the miserable states, the bulk of the population of the Arab world enjoys standards of living that are significantly below those that prevail in south Asia and on a par with those in most African societies. There are really no rich Arab states.

If you take a look within the categories that I have given you, you will find a couple of surprises as well. You will notice that in the first table, for example, that lists the four richest Arab states in terms of their standards of living, you see the four richest states are Kuwait, United Arab Emirates, Iraq, and Jordan. This, too, was kind of surprising.

The truth of the matter is that the actual standard of living in the population of the Iraqis and the Jordanians, people who by most indices, for example, by per capita gross national product, are treated as poor or middling Arab states, is actually as high as that of the richest states in the Gulf. And some of the rich, oil-producing states of the Gulf, such as Saudi Arabia, or worse yet, Oman, actually fall much, much lower in terms of their rankings when you look at their actual standards of living.

The actual stratification within the Arab world is not on the basis of rich states versus poor states, as is often imagined. It is true that there is an enormous tension in the Arab world: Between what we like to call the rich and the poor Arab states. But those are just misnomers in some ways. The tension is really between those states in the Gulf which have small populations and relatively large oil revenues, whether or not they enjoy high standards of living (I think we could properly refer to that group as the liquid Arab states, those with cash on hand) versus those other states that have large populations, relatively small oil revenues, and very little cash on hand (which I think technically should be called the illiquid Arab states). I don't expect these terms to catch on; I recognize they are kind of a mouthful. I don't expect Peter Jennings to be talking about liquid and illiquid Arab states any time soon.

But if you understand during the course of my remarks today that the real tensions are between liquid and illiquid states, not really between rich and poor, in some kind of standard of living sense, I think that will enhance your understanding of all the presentations today.

Now what have I got, 5 minutes?

In the remaining time, I am going to try to give you a detailed overview of the entire political and economic development of the Arab world over the last 20 years. [Laughter.]

Again, I want to start out with three basic kinds of points. Then, if I don't finish, you can refer back to those and kind of see where my argument was headed.

The first thing that I think you should all know is that, in the 1980's, the Arab world as a whole entered an economic crisis which had profound political repercussions. Essentially, across the Arab world, one regime after another discovered that the institutions they had developed to maintain political order could no longer be sustained by the economies of the region.

There was a downturn in the economies and an increase in the cost of maintaining political order that created the kind of crisis in what scholars call "the Arab state system," that coterie of arrangements among Arab states which has provided a modicum of political stability in the region in the 1970's and in the 1980's.

Second, that as this crisis developed and expressed itself, one of its symptoms was the confrontation between Iraq and Kuwait. Just one of the symptoms; there are other ones that we can see on the horizon that developed more quietly off in the corners. But the truth of the matter is, to really understand the broad background of the Iraqi-Kuwaiti confrontation, I think you're going to have to understand these broad changes in the economic and political developments that preceded it.

And the third thing that you should understand, which I may not have time to get into in any detail in the time which remains to me, is that Operation Desert Storm, whatever its military success, whatever it did for American influence in the region, as a point of fact made the economic and political problems of the Arab states much, much worse than they were, even at the end of the 1980's.

The region as a whole is much poorer than it was at this time at the beginning of last year. And the inequalities between Arab states, the tensions between the liquid and the illiquid states, have been greatly aggravated by the course of the War.

Actually, I would love to just leave it at that. [Laughter.]

Let me see if I can sketch out real briefly the substance of the argument.

I noticed some of you were smiling when I talked about political order in the Arab world. It almost seems like an oxymoron. The Middle East is not thought of as a region that possesses political order. After all, this is an area that in the last 10 years brought us civil wars in the Sudan and Lebanon, and confrontations between Arabs and non-Arabs in the form of battles between Syria and Israel or between Iran and Iraq. But you have to take it from someone who has been working in the area for 20 years that, in point of fact, the 1970's and 1980's were a period of relative political stability in the region. It may have looked very violent by the standards of Iowa, but compared to what preceded the 1970's and the 1980's, compared to conditions in the 1960's, this was a golden age for the Arab world.

To go back to the 1960's, you find that the Arab world was wracked not only by the Lebanese and the Sudanese civil wars, which go back 20 or 30 years, and the conflicts between Iran and the Arab states or between Israel and the Arab states, which also have a long history, but there are also two other forms of violence which later attenuated. On the one hand, there was a much, much higher level of domestic disturbances inside the Arab states.

For example, in the Levantine states, in the illiquid states, countries like Egypt, Syria, and Iraq, there were a great many more coups d'etat, there were a great many more public demonstrations, periodic riots and insurrections. Even if you look at what are now the liquid Arab states, the conservative monarchies of the Arab Gulf, these societies faced serious challenges in the form of unionized workers' revolts, tribal insurrections, et cetera, during the 1960's.

In point of fact, both of these patterns of domestic disturbance were exacerbated by the fact that there was another kind of system or trend of violence in the region during the 1960's, which later evaporated, and this was the conflict between, on the one side, a coalition of left-wing Arab military dictatorships led by Egypt and supported by the Soviet Union, who were contending for regional hegemony with a coalition of right-wing conservative monarchies, supported by the United States, led by Saudi Arabia.

This is what my mentor, the late Malcolm Kerr, used to refer to as the Arab cold war. It was the centerpiece of Arab politics during the 1960's, but it ended at some point during the years between 1967 and 1973. It ended because a series of bilateral deals were struck between the contending parties that resulted in the formation of what Arab scholars now call the Arab state system.

Essentially the deals worked something like this: Nasser of Egypt and King Faisal of Saudi Arabia saw that their feuding was costing both of them dearly and sacrificing other objectives. So, in 1967, they sat down together and Nasser agreed to stop supporting insurrections against Saudi Arabia. Nasser had an army and had been financing tribal rebels in South Yemen and Oman and had generally been a nuisance to the Saudis. Nasser agreed to stop doing that and, instead, to devote his military attention to non-Arab threats in the region, to focus his attention on Israel. A similar deal was struck with the Iraqis later who agreed to focus their attention on Iran.

In exchange for this, Saudi Arabia made a deal as well. In exchange for Egypt halting its part of the Arab cold war, Saudi Arabia agreed to start transferring large quantities of petrodollars to the illiquid Arab states in order to support their economies. It was a very nice, balanced, symmetrical deal that provided the Arab world with two things.

First, it led to a much, much lower level of domestic violence throughout all Arab states. Without the Egyptians egging them on, there were fewer tribal revolts in Saudi Arabia. Since the governments of countries like Egypt had more money, they were able to start laying on consumer subsidies, creating massive public employment programs, and otherwise intervening in their economy in a way that made their population more content.

So it ended domestic violence, but it also created a kind of regional security system which insulated countries like Saudi Arabia, Kuwait, and so on, from their more aggressive neighbors. The system continued to function politically right up until August 2, 1990, right up until the moment Iraq invaded Kuwait. And then it fell apart.

We'll hold it there.

Mr. WOOTTEN. Thank you, Yahya.

We would like to turn now to a discussion about the economic relationships between the various countries that make up the Middle East. Our next presenter, Mr. Hani Findakly, who is President of Potomac Capital, Inc., in New York City, is very well-qualified to do that.

Before joining Potomac Capital in June 1989, Mr. Findakly was Managing Director of Paine Webber, Inc., with responsibility for global risk management and proprietary trading in the U.S. and international capital markets. He was also a member of Paine Webber's senior management council.

From August 1986 to March 1988 he was Senior Vice President of Drexel, Burnham, Lambert, and Director of international fixed income capital markets. He has served as Chairman, Director, and Chief Executive of Drexel's international subsidiaries with offices in New York, London, Zurich, et cetera, et cetera.

From 1972 until 1975, Mr. Findakly was a member of the faculty and research staff at MIT in Cambridge. Prior to that, he graduated from MIT, where he obtained his master of science and doctor of science degrees.

With that, I would like to turn the dais over to Mr. Findakly.

STATEMENT OF HANI FINDAKLY, PRESIDENT, POTOMAC CAPITAL, INC., NEW YORK, NY

Mr. FINDAKLY. Thank you very much.

In this presentation, I shall attempt to sketch a broad description of the prevailing economic and financial conditions in the Gulf region in the period preceding the War.

The War in itself has created certain new conditions, including physical damage, that require immediate attention. However, the basic conditions that prevailed before the War remain in place, and deserve equally the same attention as would have been required prior to the War. In discussing the broad economic issues, my focus will be on those key elements whose reform will be critical to the functioning of the economy at large.

My basic theme is that, while the economies of the region vary dramatically from one country to another, they share certain important common attributes. This would apply to both to the haves and the have-nots. I believe that the treatment of these common features is a key to prosperity and regional economic stability.

Because many of these problems require radical and innovative solutions that would pay dividends only in the very long run, I am somewhat dubious about any quick-fix ideas that can only pay short-term dividends, but would treat the symptoms rather than the causes of these problems. Quick fixes, such as debt forgiveness or new loans, should only be considered in the context of, and as a condition to, an overall economic program that addresses reform of the general structures of economic and financial management.

The key differences that exist among the economies of the region are obviously the wide gap in the resource endowment between a sparsely populated group of countries in the Gulf and a more populous, but poorer, group on the periphery. That second group is also highly indebted to the outside world, with debt ratios comparable to those of many Latin American countries.

While the issue of resource transfers between the haves and the have-nots has solid merits, such transfers should be considered in context of a new focus on restructuring the economies of the region and enhancing synergies amongst them that would create jobs and wealth, which are far more important for longer term prosperity. The War itself has caused significant loss of income and brought about enormous damage to the infrastructure. This will leave the region poorer in resources than before.

However, the postwar conditions may offer some unique opportunities for creative economic solutions, not unlike the ones facing Europe and Japan after the Second World War. These opportunities should be seized upon to help lay the foundation for shaping a stable, long-term, regional economic order.

The most important and common thread that runs through the economies of the region is the dominance of the public sector over all aspects of economic life. This is just as true in countries such as Egypt and Iraq as it is in Saudi Arabia and Kuwait. One gets the impression on the outside that some of the large oil producers in the Gulf have a significant private sector. Yet, from a macro perspective, the size of the public sector in these countries in relation to the economy can be just as large as one would find in the Soviet Union or in other Eastern European economies.

In the oil-producing countries, the oil sector dominates the economy and its benefits trickle down very slowly to the private sector. Most of the major infrastructure projects and industrial ventures are government sponsored. Despite the existence of nascent stock markets in a few countries, such as Kuwait, Turkey, Jordan, and Egypt, there are no broad ownerships of major corporations in any country in the region.

The public sector not only dominates economic output and financial flows, but it also regulates the formation of and activities of private enterprises in a manner that inhibits their serious development. Some of these regulations are geared toward discouraging competition with public sector companies; others limit the entry of new private companies under the guise of protecting existing companies; and still others limit the entry of foreign companies into the local market. Kuwait, for example, does not allow any equity ownership, including real estate, by nonresidents.

During the 1970's in Saudi Arabia, the process of the so-called "Saudiazation" of private entities forced foreigners to sell at least 51 percent of their holdings of banks and other enterprises to local investors. Iraq has only allowed limited joint ventures, with severe restrictions that discourage all but the most desperate of investors. Only Turkey has offered meaningful opportunities to foreign investors to acquire local equity in their recent experiment of economic reform.

The second feature that is common to the economies of the region is the general lack of objective financial management and fiscal and monetary policies. There are three related issues that merit discussion in this regard. The first relates to interest rate policy, the second to exchange rate mechanisms, while the third issue relates to the financial infrastructure. I shall address these issues individually, because the overhauling of the financial system is, in my view, a major prerequisite to the building of modern economies in the region. I will also deal briefly with the issue of external debt, insofar as it pertains to some of the countries in the region.

Most countries of the region have no consistent and well-articulated monetary policy. The central banks of the region are not independent, and do not set realistic interest rate or exchange rate policies. For the most part, interest rates appear to be set arbitrarily, mostly at low levels that provide no incentives to save or to hold the local currency. This policy of low real interest rates has three distinct disadvantages.

First, it discourages savings and encourages more speculative investments, such as real estate. In the process, it diverts funds away from the banking system that may be recycled into productive investment.

Second, it encourages capital flight. When investors in Kuwait, for example, can earn a 2 or 3 percentage point premium on their dollar deposits than on comparable Kuwaiti dinar deposits, they will opt for the dollar investments. Since the foreign exchange risk is deemed to be minimal, investors are almost always guaranteed an arbitrage profit.

Indeed, that phenomenon has encouraged investors to borrow the local currency, and convert it into dollars that are invested abroad at a healthy profit. But this and other speculative games got out of control when investors became greedy and sought larger returns in the early 1980's, causing the so-called Souk Al-Manakh problem.

This problem kept Kuwait, Bahrain, and most of the Gulf countries under severe financial strain for most of the 1980's. The losses that resulted are estimated at some $100 billion which, relative to the size of the respective economies, make the savings and loan problem in the United States a mere picnic by comparison.

The Iran-Iraq War aggravated the economic recession and, with few exceptions, rendered insolvent most of the local banking and financial institutions. They were only able to operate under heavy government subsidy and accounting gimmicks.

Similar speculative real estate bubbles in Saudi Arabia and the United Arab Emirates have also weakened the foundation of the banking system. When one considers the fact that the Gulf region is among the most overbanked regions in the world, it is reasonable to expect a period of consolidation and mergers of banks for the coming decade.

The third problem with maintaining low or negative real interest rates is that government deficits are financed through the central banks by printing money, instead of traditional borrowing from the public. Since these central banks are not independent, this printing of money will, over time, debase the value of the currency. Iraq has become a classic example of this policy, where the real value of the currency is little more than the cost of the paper and ink used to print it.

By contrast, Turkey has embarked on a policy of maintaining high real interest rates and has started a moderately successful borrowing program that is patterned after the U.S. Treasury public auctions of debt and after Federal Reserve open market activities.

The second issue in financial management is the policy of setting unrealistic exchange rates. While many countries in the region have abolished exchange controls, the exchange rates are still controlled, and are primarily linked to the U.S. dollar. Except for countries such as Iran and Iraq, most countries in the region place no restrictions on the movement of capital. Thus, as a result of the unrealistic exchange rate policy, a number of these countries have experienced severe capital flight as well as major economic distortions.

Capital flight in the region generally takes two forms. First, the local public transfers money for investment abroad seeking higher returns or seeking political diversification away from the home currency. Since exchange rates are relatively stable against the U.S. dollar, there is little or no financial risk to the public engaging in these activities. For example, throughout most of the 1980's, when oil prices gyrated between $10 and $40 per barrel, and as the U.S. dollar changes in value by more than 50 percent against major OECD currencies in both directions, the Kuwaiti dinar fluctuated in a range of less than 10 percent against the dollar. The second form of capital flight is caused by the large expatriate labor in the oil-producing Gulf countries, such as Saudi Arabia, Kuwait, United Arab Emirates, and Iraq.

In the case of Iraq, expatriates also faced two problems. One was a restriction on the amount of funds that can be transferred abroad. Another, more serious problem was the sharp and increasing gap between the official exchange rate and the free market rate for the currency. Because the currency has been kept at the same level since the 1970's, a large gap existed by the late 1980's between the two rates. By 1990, the black market rate was about 10 times the official rate, a level comparable to those existing in the Soviet Union.

Unrealistic and mostly overvalued foreign exchange rates also create enormous distortions in the economies of the region, beyond encouraging capital flight. Essentially, they subsidize imports and encourage consumption, and in countries such as Iraq and Egypt they discourage agricultural production and make other local products uncompetitive. Furthermore, they discourage the entry of foreign capital into the local economy, to the extent that such capital may be available for domestic investments.

It can be argued that the experience of postwar Japan, Europe, and more recently Korea in pursuing a policy of undervalued exchange rates played a major role in their subsequent economic performance. The dilemma that most of the region faces in this regard is that a major currency devaluation will create a shock to the system that could aggravate an already fragile economic (and political) structure. Such a shock will arise because import costs of all essentials, including food, will rise sharply beyond the reach of the public and is therefore politically difficult to fathom.

My view is that the governments already subsidize imports through the exchange rates, and therefore why not cushion the decline by direct subsidies of important items relating to food and shelter. Over time, this subsidy should be phased out to allow the market mechanism to determine appropriate wages and prices.

Indeed, this issue will be the priority item facing the Kuwaiti government now, which I understood has decided to devalue the currency by about 25 percent, and may need to devalue further in the coming months. Iraq will have to face similar decisions down the road, although the problems there are far more complex and the shock will be far more severe.

My third observation about the financial management of the region's economies relates to the absence of an efficient financial infrastructure. Without an effective system that harnesses private savings and channels them into productive investments, it is difficult to envisage how a modern economy can function properly.

The financial landscape in the Gulf region, with the notable exception of Kuwait and perhaps Bahrain, resembles that of many developing countries. Kuwait's financial network is probably the best in the region and could conceivably compete with many Western systems. The region could well benefit from the general experience and financial skills that Kuwait has developed.

More recently, Turkey has taken major steps to develop a modern financial and banking system. This system includes a modern stock exchange, investment banking infrastructure to help raise debt and securities for public and private entities, commercial banks, and special purpose institutions that channel capital to areas such as housing, agriculture, and industry.

Jordan and Egypt also have small stock exchanges, but they are too small and too limited to provide a major source of capital to the private sector. They also suffer from overregulation of an oppressive bureaucracy, particularly in Egypt. That explains why the market capitalization of the Cairo Stock Exchange equals about $1.7 billion, compared to $2.2 billion in Jordan, $6.8 billion in Turkey, and $10.6 billion for Portugal.

To put into a proper perspective the challenges of building a modern banking system in the Gulf region, I would like to tell you a story that was told to me by the secretary to a chairman of a Kuwaiti bank that I visited last year. While waiting for her boss to emerge from a board meeting and responding to calls and inquiries, she told us how she dislikes working in the executive suite and would love to go back to dealing with customers as a teller. One of her fond memories related to the time in the mid-1980's when the bank switched into automatic payroll deposits for its employees. For several months afterwards, she said, employees would come on pay day, demand to check their balances, cash their paycheck, count the money, and redeposit the entire amount.

This need to have a tangible feel of one's possession, in more sophisticated Kuwait, suggests the need for a major educational effort to help transform and overhaul the region's financial system. It is about changing cultures, part of which has to do with public, but a larger burden falls on the governments themselves. To some extent, some of that change is already taking place.

The Istanbul Stock Exchange, for example, has exhibited some unique and amusing seasonal patterns. This seasonality centers around planting and harvest times: After the harvest, the market goes up as farmers put their money in the stock market, only to sell before planting season to pay for seeds, fertilizers, and equipment. I guess that means you better be out of the Turkish market before planting season. [Laughter.]

I should comment briefly here on the Turkish experience in liberalizing the economy. The freeing of interest rates and exchange rates has paid reasonable dividends to date, although they still face serious problems with inflation and other economic problems. During the past several years, a substantial amount of flight capital has been repatriated when local investors perceived of better opportunities to invest at home.

In 1989, the Istanbul Stock Exchange registered the highest performance, in U.S. dollar terms, of any stock market in the world. By contrast, capital flight remained high, and may have even accelerated, in most other countries of the region. It is important to observe that, when local investors take their money out, there is little reason to believe that foreign investors could find better opportunities in these markets.

Historic experience suggests that investors seeking opportunities in foreign markets use three basic tests to justify investments outside of their home country. First, they must be satisfied with the political stability of the target country. Second, they must be satisfied that the so-called sovereign investment risk—including expropriation and major currency devaluation—is limited. Finally, once the first two criteria are satisfied, investors generally demand higher returns—on the order of 5 to 10 percent more—than they can obtain at home.

None of these tests had been satisfied in the Gulf region and surrounding countries in the period preceding the Gulf War, and certainly none exist now.

Finally, in discussing the region's banking phenomena, it is significant to note the recent development of the so-called Islamic banks. These "banks" operate on the principles of Islamic finance that do not permit the earning and charging of interest. These institutions, which may be viewed as a cross between mutual funds and credit unions, have grown in size and number to become an important financial force in the region. They have managed to attract tens of billions of deposits that are now being deployed globally in trade finance, equipment leasing, real estate financing, as well as many traditional investment transactions that are structured with certain twists to suit their religious underpinnings.

While these institutions serve an important role in the regional economy, and are for the most well-managed, they are largely unregulated. This lack of regulation, both locally and abroad, could be problematic given the size of funds that flow through them. In recent years, Egypt faced serious problems as some unscrupulous individuals operating Ponzi schemes under the guise of Islamic banking caused tens of millions of dollars in losses to the public.

External indebtedness is one key area in which a clear and wide disparity exists among the countries of the region. Highly indebted countries, such as Egypt, Iraq, Jordan, and Turkey, have less flexibility in restructuring their economies and would require more leadtime for achieving success in such efforts.

Of this group, Turkey again stands out as having successfully tackled this issue. In the early 1980's, just prior to the Mexican debt crisis, Turkey was able to restructure its private debt by extending the terms of its debt by several years. It also managed to secure IMF and World Bank assistance through pioneering structural adjustment and financial reform loans. By so doing, it managed to avoid the crisis atmosphere that embroiled other highly indebted countries a few years later.

The confidence of the financial community in opportunities in Turkey was reflected in 1989 when a closed-end country fund was registered on the New York Stock Exchange to enable U.S. investors to invest in Turkey.

By contrast, Egypt has made little or no progress on this issue over the past decade, and apart from looking for handouts, there is no apparent policy shaping up in this regard. In fact, Egypt had a number of opportunities to restructure its external debt, but since most of this is to governments and international lending agencies, there has been little incentive to do so.

On the commercial debt side, there were limited attempts to exchange bank debt for equity investment in the country, but a highly confused policy limited the amount of such exchanges.

Since Egypt suffers from a serious capital flight problem, a policy that encourages the repatriation of capital, including debt-for-equity swaps at a discount to face value, could prove very effective. Indeed, private estimates suggest that Egyptian citizens, like those in Mexico, reportedly have foreign assets that are equal to the country's entire external indebtedness.

Iraq's present foreign debt is probably the highest in this group. Prior to the outbreak of war with Iran, Iraq foreign exchange reserves, of about $40 billion, were among the highest in the world. The cost of the war with Iran, and the policy of guns and butter during the war, and the heavy military and reconstruction expenditures after the war, depleted those reserves and swung the country into a major debtor status.

While there are no official statistics on the extent of Iraq foreign indebtedness, private estimates put this figure at $80 billion by mid-1990. About half of this debt was to the Gulf oil-producing neighbors, which reportedly either lent money or pumped oil from the neutral zones on behalf of Iraq. The Iraqi government must have figured that it could not simultaneously meet its debt service obligations and build its war-tattered economy. At $20 per barrel of oil, Iraq's income from exports would have been around $25 billion, almost equal to the annual debt service of principal and interest.

Therefore, the difference between being marginally solvent and totally insolvent for Iraq was whether the debt to the neighboring countries was counted on their books. That meant that any additional borrowing from the international market would have only been feasible if that debt was officially canceled.

Finally, apart from the high level of debt, the most striking element in looking at the region's external debt is the manner in which this debt is managed or, more appropriately, the way it is not managed. With a few exceptions, there is little understanding among the region's debt managers of how the world's capital markets operate, and of the attendant financial risks involved in acquiring a pile of debt.

In simple terms, many of these debt managers have very limited financial training. To put it in the context of the bazaars in the region, their only concern is how much money can I get and at what price. That exposes the country to enormous financial risks arising out of interest rates and exchange rate volatility. To recall the Mexican example, the real problem of Mexico was not the fact that its marginal borrowing cost was too high. Instead, it was because the short-term rates to which that debt was pegged rose from 8 percent to 22 percent in less than 2 years.

Another related problem that these countries face is their exposure to exchange rate movements, especially when the dollar depreciates against other currencies. In that case, the dollar value of any debt acquired in alternate currencies would rise and place additional burdens on these countries. This is especially true for bilateral debt as well as that received from international lending agencies, such as the World Bank. This issue underscores my emphasis on the need for developing sophisticated financial skills in any postwar rebuilding period.

A third and noteworthy common feature to the countries of the Gulf region is the lack of economic linkages, such as trade and investment. It is far easier to find Kuwaiti or Saudi banks in London, New York, or Singapore, than to find them in Cairo, Istanbul, and Baghdad.

To the extent that joint commercial ventures have been created in the form of banks and investment company consortia, they have largely opted to invest and lend outside of the region. While some agricultural products are traded across some boundaries of the region, these have been relatively small.

The only meaningful regional effort to encourage development and channeling of surplus capital, apart from political handouts, has been the regional and bilateral development funds. These institutions include the Arab Fund, the Arab Monetary Fund, the Arab Fund for Development in Africa, the Kuwait Fund, the Saudi Fund, and the Abu Dhabi Fund.

There are also a number of specialized investment entities, such as the Arab Petroleum Investment Corporation and the Inter-Arab Investment Guarantee Corporation. These institutions have played a limited role in channeling development funds from the haves to the have-nots.

But if there were to be a major scheme of the scale of the Marshall Plan, these institutions should be called upon to play a major role. First, because they have substantial resources of their own and could be augmented for a major rebuilding effort in the region. Second, they already possess certain skills and experience with pertinent development issues in the region. Third, they have an established operational network amongst themselves and with multilateral aid agencies, such as the World Bank and the IMF.

But for these institutions to be effective, I propose a three point program to invigorate and consolidate their efforts. First, the regional entities should be combined into one conglomerate or super aid agency. This agency should have sufficient capital and borrowing power and should coordinate to the extent possible international financial and technical assistance flows into the region. Second, they should link their public sector support with a major effort to liberalize the economy and foster the growth of the private sector. This effort should combine strict lending conditionality with direct loans and investments in private enterprises of the region. Third, the emerging entity should also encourage economic and monetary integration of the region, with a view to developing a regional common market. Such an effort could be accomplished through investments that target regional trade and through investment insurance schemes that protect against noncommercial risks.

The prewar structures of the Gulf regional economies possess a number of common features, despite the obvious disparity in wealth income. My theme has been that liberalizing the economies of the region is central to their future stability.

Despite the arcane nature of the issues raised in this presentation, I have argued that a focus on financial management of these economies is key to making such efforts effective. Over the past two decades, the oil-producing Gulf countries have been a net supplier of capital to the rest of the world, especially to the Western world. This process had stagnated during the protracted Iran-Iraq war, and capital flow to the outside world slowed to a trickle.

In the years ahead, these countries could well continue this capital outflow, but it is more likely that they will suffer serious deficits that may render them as net debtors, at least in the short run. To the extent that capital transfers occur in the next few years, it will more likely be necessary to acquire Western capital goods and services rather than stocks and bonds.

Depending on what happens to oil prices over the next several years, these countries may have to liquidate financial assets held abroad to pay for such imports. In doing so, these countries could face temporary liquidity crises that would limit the smooth transfer of wealth to poorer countries in the region.

Therefore the ideas that are being floated around regarding the creation of a super regional development agency, perhaps under the auspices of the Gulf Corporation Council or the Arab League, deserve serious consideration. Such an agency should have sufficient resources and operational independence to draw up and implement economic development in the region, and to lay the foundation for closer economic linkages within countries of the region.

Mr. WOOTTEN. Thank you very much, Mr. Findakly. I'm sorry, we have to stop you there.

Richard, you had a question?

THE EFFECTS OF WAR ON ECONOMIC REFORM

Mr. KAUFMAN. I'd like to pick up the issue of economic reform that was raised in Hani Findakly's presentation, and ask Professor Sadowski to discuss the effects of the War on the economic reform initiatives that were in progress in some of the countries before the

War, and, second, to discuss briefly the issue of economic reform in the context of political reform and how to link the two phenomena in this region. Briefly. [Laughter.]

Mr. SADOWSKI. In the late 1980's, for the first time in 30-odd years, a dozen-odd Arab states began experimenting seriously with different kinds of economic reform programs. It was a very painful process for them. In the few cases where Arab states have tried to undertake reforms in their exchange and interest rate policies, cutting back on the government subsidies and reducing the size of the public sector, they have triggered so-called IMF riots. There was a major one in Egypt in 1977, and in Tunisia and Morocco in 1984 and 1985, and in Algeria and Jordan in 1988 and 1989.

Despite these riots, through the 1980's the pressure was building on the governments for entertaining more and more serious, more and more ambitious reform programs largely because of debt and aid pressures.

In the earlier period, it had been possible in the early 1980's for Arab states to kind of muddle through because the illiquid states which are the ones where the reform experiments were going on were receiving large volumes of aid from other Arab states that dropped off during the 1980's. Saudi Arabia was giving $5.6 billion a year in assistance to illiquid Arab states in 1980. By 1990, that had dropped to under $1 billion.

Likewise, there was additional pressure in the form of debt service. At the beginning of the 1980's, the debt service ratios were very small across the Arab world. They rose sharply during that period. Egypt borrowed $50 billion; Algeria borrowed $25 billion; Morocco borrowed $20 billion; and so on.

By 1986, the Arab states collectively were paying out about $11 billion a year in debt service, and that was projected to rise to $22 billion a year by 1993. This gave international agencies such as the World Bank, the IMF and so on additional leverage on Arab countries, basically by blocking their efforts to reschedule their debt unless they were going to engage in serious policy reform. It looked in 1990 like half a dozen Arab states—Algeria, Jordan, perhaps even the Sudan and Egypt—were looking at serious economic restructuring efforts.

But the Gulf crisis in many ways has blown those completely out of the water. On the one hand some of the countries which were furthest along in their reform efforts have now been relieved of much of the pressure that they were experiencing in 1989–90 to make changes. Syria and Egypt, for example, were in fairly desperate economic condition a couple of years ago, but both of them benefited from the Gulf crisis in the form of direct aid from the Arab states, debt forgiveness on behalf of the Arab states and/or the United States, and through other kinds of measures. The reform process in these countries will probably be slowed because the pressure has been relieved.

On the other hand, among some of the most illiquid Arab states, economic problems that these countries were facing have become so absolutely desperate that governments are far more reluctant than they were in the past to engage in any kind of reform that would affect the population's standard of living in countries like the Sudan, Jordan, and Yemen, which were very heavily dependent upon workers remittances for much of their hard currency for example. The economy has been absolutely devastated by the Gulf War: 750,000 Yemenis have been expelled from Saudi Arabia; 300,000 Jordanians and Palestinians have returned home from Kuwait. Even Egyptians have seen almost half a million people return home from the Gulf.

And as the populations from these countries approached their minimum level of tolerability in the reduction of their lifestyle, the governments have become more and more reluctant to engage in dramatic reform measures that would have the effect of pushing these people below the subsistence level.

PROSPECTS FOR DEMOCRATIZATION IN THE GULF REGION

Mr. KAUFMAN. When I mentioned political reform, what I meant was democratization. Are there any realistic prospects for democratization, let us say, in the Gulf states of Kuwait and Saudi Arabia? What would be the consequences of democratization on the economies of those states, and the enormous control the ruling families have over the economic resources?

Mr. SADOWSKI. Again if I can give a slightly broader picture of things, there is a direct linkage between economic reform and political reform in the Arab world.

The truth of the matter is, those Arab societies which have, for example, experimented with mass elections, with parliamentary institutions and so on during the 1980's did so largely as a sop to their populations on whom they were going to be introducing new levels of economic austerity.

The Jordanians, for example, revived their Parliament in 1988 precisely in order to renew some political legitimacy that the monarchy had lost after adopting IMF-style economic austerity programs.

The same thing is true with the democratizing trend in Algeria, for example, and even to a certain extent in Egypt. But there is a dilemma that these governments face.

On the one hand, by democratizing, by including the public, by expanding political participation, they can gain an element of political legitimacy that offsets their declining popularity as a result of harshening economic circumstances.

But in the course of democratization the trend has been very, very clear. The victors in the new elections that are being held around the Arab world have almost overwhelmingly been from the Islamic fundamentalist movements, who are the groups who have been the most articulate critics of the existing orders and their economic and social failings.

So, even for the United States, there is kind of a dilemma when we look at the issue of democratization in the Arab world. We in the United States tend to think of democratization, or political reform as being a process that involves two separate elements. One of them is the expansion of political participation, the creation of elections, and so on. The other one is the extension of civil rights and liberties, guaranteeing freedom of the press, freedom of association, basic human rights, et cetera, and those two goals do not go hand in hand in the Arab world.

If you push democracy in the narrow sense from expanded political participation, the victors wind up being the Islamic movements. They will genuinely win the popular vote in most cases. But these movements, although they favor democracy in that narrow sense, do not favor the expansion of civil liberties. They do not favor the extension of human rights, freedom of the press, and all these kinds of things.

So both we in the West who would encourage political liberalization in the Arab world, and those regimes in the Arab world that are contemplating it as a response either to their own economic crises or out of some genuine broader commitment to political development, face this contradiction and this dilemma.

You have democracy or civil rights but not both.

THE U.S. ROLE IN THE GULF IN THE AFTERMATH OF THE WAR

Mr. **KAUFMAN**. I might ask one question of Mr. Findakly. What do you see as the possibilities for a U.S. role in the region with respect to reform and the financial requirements of recovery and reconstruction?

Mr. **FINDAKLY**. I think the U.S. role need only be a catalyst role. We do not have that much resources in the region, really, to invest in a major political reform in those countries.

We might provide an enormous amount of technical assistance to those countries, into the shaping of those economic reforms. We might also induce the international lending agencies—the World Bank, the IMF and a number of others—and maybe help create a special-purpose institution such as the one I referred to that would intermediate funds.

It is a little bit of a dilemma for us. That is, that those so-called liquid Arab states, particularly Saudi Arabia and Kuwait, are likely to be a lot less liquid in the future. It depends very much on what happens to oil prices.

If oil prices stay at current levels, those countries are likely to be net disinvestors, and will bear the brunt of that, because they've been investing fairly heavily in U.S. markets and Western markets. They will end up liquidating that in part to meet obligations they had for the War, and in part help the rebuilding process and the transfers we are talking about from the liquid to the less liquid.

More recently, Saudi Arabia has been reported to be negotiating loans from a syndicate of banks. I certainly do not personally believe that they need the money right now, so they are doing it for one or two purposes. One is to test the market. They are not used to the idea of borrowing money. They have never done it. Or it might be a political way of saying that we are ourselves suffering some liquidity squeeze, so we're not going to be providing money very quickly.

The Kuwaitis have been selling an enormous amount of debt assets.

In fact, they are reported to be borrowing against some of the securities they have in the United States to the tune of $4 or $5 billion a day, and they will probably do more of that. So the quick answer to your question is: Very little by way of actual money transfer, and mostly inducing the international lending agencies in the shaping of political reforms, economic reforms, as well as in the shaping of current institutional structure.

Mr. WOOTTEN. There is a question right here in the center.

DEMOCRATIZATION IN A PATRONAGE-BASED POLITICAL SYSTEM

QUESTION FROM AUDIENCE. I guess to follow up on one of the earlier questions, I guess this is particularly to Mr. Sadowski. One characterizes the political system as based on patronage. How does political democratization—you say there was a contradiction between economic openness and political democratization. How can you economically open up the system when much of the regime is based on patronage from the top?

Mr. SADOWSKI. The experiments we have seen with democratization in the Arab world have been very limited. There has been no Gorbachev who has threatened to overthrow the system and replace things with a new political order.

By and large, the leaders of the Arab states have spent the past 15 years engaged in short-term accommodation. They imposed some economic austerity measures which they hope will buy them debt rescheduling, which will put off the problem of more fundamental economic reform until some future date when conditions may be better.

Likewise, they have engaged in limited democratic reform to buy them the political legitimacy necessary to engage in economic reform in the hopes that they can put off a broader political change until some point in the future when conditions are better.

This dream that in the future conditions are going to get better has been one of the great burdens the Arab world has had to carry over the past 15 years. There has been this burning hope that at some point oil prices are going to go back up again and deliver all the rulers of the region from the responsibility for confronting these political and economic problems.

To give you an example of that, in 1982 the Arab world exported $212 billion of oil in current terms. By 1987, in 5 years, that had slid to $95 billion. Now all during the last year, we have seen the same kind of wishful thinking on the part of the Saudis and the Kuwaitis, for example, or Jim Baker when he proposed the Middle East Development Bank; on the part of Gephardt when he claims that the Saudis can pay for Operation Desert Storm out of their pockets sort of thing.

A lot of people thought that, because oil prices had gone up a bit last fall, there was going to be maybe a $45 or a $60 billion oil windfall in Saudi Arabia last year which was going to enable them to do all kinds of things.

In point of fact, the oil windfall of Saudi Arabia last year was between $14 and $16 billion, depending on whose figures you take. I do not think, when the Saudis go out and borrow money, that they are just testing the market.

I have the figures for what they spent last year as a direct result of the Gulf crisis: $12 billion on new armaments; $4 billion on resettling Kuwaiti citizens; $4 billion on opening up mothballed oil production facilities; $2 billion a month on supporting the Allied war effort; $3 billion into an account for Egypt's economic subsidies; et cetera.

When you add it up, by the end of the year the Saudis overspent their oil revenues by $27 billion by the end of 1990. And I am afraid that when you look, it is very difficult to predict what is going to happen in the oil markets, but there is certainly nothing at the moment that indicates that there is going to be a significant increase in prices over the next 5 years.

If anything, there is a very serious danger that, with everybody having increased their pumping over the last 6 months in order to take advantage of the slightly stiffened prices, if the Kuwaitis and Iraqis come back on the market, there will be a general collapse of prices.

Even with the problems that do exist in terms of financial accounting, economic data, and so on, there is clear evidence that the Saudi budget in 1990 was in the red.

The projected 1991 budget is also projected to be in debt. In relation to the oil crisis, given the overhang of reduced capacity which could be up to 9 million barrels of oil per day, there is not a chance for them to have any recovery in price over the $19 to $21 a barrel average.

It was clear in November 1990 that irrespective of the outcome of the Gulf crisis, oil prices could not be brought up either artificially or by unconventional market situations in the near future or in the extended future; that is, 4, 5, 6 years.

Mr. **Wootten**. Over here.

THE MIDDLE EAST AND ECONOMIC REFORM

Question From Audience. How do we convince the governments in the Middle East that economic reform is in their interest? This is what I think is the crux of the problem. I mean, everybody knows that the primary requisite for these governments to survive, or these states to survive, productively in the 21st Century is stronger, truly productive economies which, you know, if you really look at the Arab world, almost none of the Arab states have.

But when you talk to Arab policymakers, very few people are convinced that economic reform will yield the benefits that we say it will. And I do not know how to get beyond that. Maybe it is the fact that they do not believe, beyond the very near term in a sense—maybe Professor Sadowski can answer that.

Mr. **Sadowski**. Hani, do you have a comment?

Mr. **Findakly**. There is no way you can do that, to start with. It has not proved useful. I suppose one way you do that is not to give them any money unless you tie it to very serious conditions.

I personally think it is going to be impossible in the future because the ability to get a lot of bilateral aid from Saudi Arabia or from the other Gulf countries, or indeed from the West in a major way is going to be limited. So a lot of it may have to be channeled through some of these bilateral/multilateral institutions that will be better able to handle conditionality than, for example, AID could, or any of the bilateral agencies could.

Mr. **Sadowski**. I am very pessimistic about the prospects of changes here. I tend to dissent a little bit from the conventional wisdom in this town, which is that economic reform in the Arab world does not occur because Arabs do not understand what benefits would be involved.

I think they see very clearly what the benefits might be, but they also understand better than some people here do just how incredibly painful the political and economic price of engaging in those reforms is, and they make very savvy calculations about it. "God, if we can avoid dramatic reform and get through on some basis of satisfying measures, let's do so."

They have seen through the conditionality argument, too. We have been trying for the past 10 years to encourage reform by threatening to hold up debt rescheduling or cut back on aid to countries which do not engage in serious economic policy reform, but the Arab states have been in this position and understand that ultimately the basis of aid, whether between Arab states or between the United States and the Arab countries, is political not economic.

We give money to a country like Egypt or Jordan in order to support a certain political pattern of alliances. The Saudis give money to their neighbors for political reasons, not economic reasons. And if they push things hard enough, we will discover that we cannot afford to cut them off completely because we cannot afford the domestic turmoil and change in government orientation that might result.

Mr. **Wootten**. I think that is an excellent point on which to end our first panel. I am sure you agree with me that the economic picture that was painted by the panelists is convoluted, to say the least. I think the message is clearly that all of us here on the Hill will have to take a close look at the proposals being made for correcting the problems in the region and helping pay for the damage caused by the War.

For now, we are going to take a 5-minute break, and then get into our next panel, which should complement this one very well.

[A short recess was taken.]

Mr. **Wootten**. Could we take our seats, please. Thank you very much.

Before starting the second panel, I would like to give Richard Kaufman a chance to say a few words.

Mr. **Kaufman**. First, I want to draw some attention to the tables that were handed out before the first panel by Professor Sadowski. I also handed out a table labeled "Economic Profiles of Selected Middle East Countries."

I think if you compare the numbers in the two sets of tables you will see that they confirm exactly what Professor Sadowski was saying about the range of estimates and the great uncertainty in statistics about the countries of the region.

The table that is labeled "Joint Economic Committee Staff," by the way, is based on data from the 1990 World Fact Book published by the CIA. So in some sense, they are the official government figures, although there are many footnotes and qualifications to the numbers in the original source that are not in this table which does reconcile some of the differences between these figures and those that were used by Professor Sadowski.

We hoped that in the first panel we would have a good discussion of the domestic factors in the economies of the region and the international financial factors. We were very fortunate in getting both of those aspects. We now have a foundation for discussing the actual economic consequences of the War, and for inquiring into the political context.

Mr. WOOTTEN. I also want to direct your attention to several CRS documents that were placed on the table outside the door where you came in. I think you will find them helpful in sorting out the facts in what I think you will agree is a rather unique economic environment.

There are a couple of Issue Briefs by Gary Pagliano from our staff, and another by Steve Daggett, also from CRS. And then there is a very recent report, "The Background, Restoration, and Questions for the United States," by Ted Gray, an analyst here in the Foreign Affairs Division on Kuwait.

I think Ted's paper really does set the scene, and I would like to commend it to you. If you have not already seen it, take a copy along as you leave.

Our next panelist, Professor Bernard Reich, is a veteran of the Middle East.

I have known Professor Reich for a long time and his bio reads like a who's who among scholars of the Middle East. Bernard is professor of political science and international affairs and Chairman of the Department of Politics at George Washington University. He's written so extensively about the region that it's not possible to list his publications in the time we have here.

He's also chairman of the advanced area studies at the Department of State's Foreign Service Institute, and is a member of the adjunct faculty at the Defense Intelligence College at the Defense Institute of Security Assistance Management. Bernard has acted as a consultant and lecturer for many years.

I've asked him today to keep the economists honest, if you will, by reminding us of realities in the Middle East. We tend to forget just how intertwined and linked the economic and political situations are. So I've asked Professor Reich to provide a survey of the situation, with some special emphasis on how it ties into the economic picture.

STATEMENT OF BERNARD REICH, PROFESSOR, POLITICAL SCIENCE AND INTERNATIONAL AFFAIRS, DEPARTMENT OF POLITICS, GEORGE WASHINGTON UNIVERSITY

Mr. REICH. Thank you. Unfortunately, Professor Sadowski used most of my jokes and certainly half of my material. So I will build on what he said. I'm going to try to raise a series of questions and suggest a framework, rather than getting into all the details. No academic can speak for 15 minutes. [Laughter.]

The minimum is an hour and 15 minutes, preferably twice a week for 15 weeks. [Laughter.]

While eschewing policy prescriptions, the purpose of this brief discussion is to outline the major political trends that will affect postwar economic recovery in the Persian Gulf and other sectors of the Middle East.

Let me start with several basic reminders, if I may. The first is that, while economists discuss all kinds of balances of numbers and of accounts, and of things like trade, and where the money's coming from and where it's going to go, the level of debt and all the rest, I think we should remember that, in much of the Middle East, people who make the decisions or determine how those issues are going to be handled are in fact people barely schooled in economic matters and who, in most cases, worry less about economic reality than what the economic reality will do to their political reality, which is ultimately survival. I think we should not forget that, although it's been hinted at a number of times earlier this morning.

So political reality is the ultimate, if you will, in terms of conditions and what the decisionmakers will do. And since, in most of the states of the region, economic decisionmakers hold their posts at the behest of the political decisionmakers, we should recognize that ultimately it's political stability that's going to make the difference.

The second thing, it's important to remember that we're sitting here at a time when all of the outcomes of the recent turmoil in the Middle East and all the ramifications of what took place are, I would say, not even fully clear. They're not even beginning to be clear for some of the states of this area. And we can all speculate and postulate as to what may be in 6 or 8 or 10 months from now. But we are likely to be as wrong as we're likely to be right.

My favorite comment was repeated just this morning on television. One analyst suggested that the probability of Saddam Hussein's being in power a year from now is 50-50. [Laughter.]

Which is something I certainly can't quarrel with. But which 50 am I on? [Laughter.]

I think we have a problem not only for the stability and for the future of Saddam Hussein, but the stability of Iraq. What will Iraq look like a year from now? Never mind what some of the other states in the region will look like.

And until we begin to get a better handle on some of these issues, we're going to have some problems figuring out the economic possibilities. First, you have to have a country and government in place. The leaders and decisionmakers have to be identified. The main issues facing those systems have to be clarified and the mechanisms for dealing with them have to be ready to function. And then you can begin to tackle some of the more ticklish problems, such as what price for a barrel of oil you would like to see established; how you are going to get there; and what that is going to do to whether or not you are a creditworthy borrower in the international financial markets.

I think we've seen from the Gulf crisis that the price of a barrel of oil is not an economic decision unless you consider the fact that the demand side of the equation always includes a political element. The price of a barrel of oil has demonstrated quite clearly over the last couple of years that the political factor, the psychology, if you will, is an important element.

I was reminded of this when Sheikh Yamani earlier in the crisis projected that the price of a barrel of oil could wind up anywhere from $15 to $100, depending upon which of the alternative scenarios you preferred. And when asked which one he thought was the most likely, he suggested that was not his kind of analysis, which means you have a full range. And I think he was absolutely right. He was totally wrong in suggesting that we would get anywhere near $100, and very much off when he thought it would be at $15 once the War was over. We may be moving in that direction but we're not there. We have to recognize the political element in the equation.

Second, economic recovery cannot be established on the basis of political turmoil and instability. While that's a clear factor in the region, some of the developments of the postwar system are already clear and beginning to be established. But let me include a couple observations and warnings. Almost every war in the Middle East since World War II has been seen as a watershed and has been followed by a certain euphoria, that we now have new opportunities and possibilities to take care of all of the political security and economic ills that were in existence prior to that conflict. The region generally has seemed brighter in outlook and more ready for peace and security after a war than at other times and often the postwar euphoria has led to hasty and failing moves.

Professor Sadowski kept mentioning 30 years of working on the Middle East. I was reminded just yesterday that I've been doing it for just about the same amount of time. In those 30 years, I have yet to see the euphoria of the immediate postwar Middle East translate into short-term achievements or accomplishments of a noteworthy level.

That's a broad generalization. Some of you may want to take me up on that later. But I'd be hard pressed to find a single war which had an immediate, very positive outcome.

The other thing is that we always seem to think we can separate out some of these issues in order to handle them more neatly. For example, the notion that economic recovery can be separated from the questions of political stability, security, settlement of the Arab-Israeli conflict, arms race controls and related matters. I would suggest that all of these issues remain interrelated. These days we have to be very careful with the word "linkage." But they are all interconnected. They always have been. And I would suggest they are always going to be.

If you want to talk about economic decisionmaking and economic recovery and at the same time talk about an arms purchase scheme that might need $13 to $15 billion in the first year, you're really talking about decisions of guns versus butter in the most primitive sense of that concept. The King of Saudi Arabia, if, in fact, what we heard earlier this morning is the case, needs to get sufficient revenues to pay the bills of the War at the same time that he requires funds to buy the weapons he thinks he needs and at the same time contribute to economic recovery in his own country and in the region more generally, never mind paying premiums on the national life insurance policies he's now taken out with the Syrians and the Egyptians.

What we have is a very significant question of where do you put your money. That's going to bring us back to this matter of all issues ultimately being linked. Is the region more amenable to solutions now than it was before? I would suggest to you that at least thus far the likelihood of a dramatic breakthrough on most of the regional problems remains a secondary consideration to the establishment of domestic tranquility, stability and even legitimacy.

Notice I left out the word "democracy," since I basically adopt the principle that the likelihood of democratization of the states of the region, as we know and understand that term in the West, is extremely unlikely in the short term. By that I mean the probability of creating the frameworks necessary, the ideological conception for convincing the leadership that they ought to grant democracy is going to be a problem.

That last point reminds me that some months ago the New Yorker ran an interesting cartoon that showed a general in full uniform standing on a balcony in front of a population of hundreds of thousands in the square below and saying to one of his aides, "If I had realized they really wanted democracy, I would have given it to them months ago," which, of course, illustrates the basic point that their concept of democracy may well be different from the way we see it.

What's likely to happen out there? I've suggested some of the themes. Let me put it in a more analytical and orderly perspective. There are three levels of political concern we have to have in the region. They are obvious—domestic or internal developments; regional interactions; and, finally, what external powers will do politically or will not do politically with regard to the region. On the domestic level, I think we should be more concerned in the short run. We need to worry in the short run about political stability and tranquility and not be enamored of that wonderful concept—democratization. Democratization may eventually be a possibility for some of these states. But I would suggest that, until the states of the region have reestablished their legitimacy in some cases, and certainly reestablished their control in others, and assured a measure of tranquility, we're ahead of the game. If we begin to talk about democracy, we may well find that if we push in one direction at the same time that we push in all the others that we are going to find that none of these goals are going to be achievable.

In the case of Iraq, I'll be very careful. I have two basic sets of questions. One is, will there be a year from now an Iraq in toto as we now have it, or will, in fact, there be some of this breakaway situation that we've seen with the Kurds in the north, in particular, which is much more crucial in my mind than the question of the south?

The second question will be who is going to run whatever remains of Iraq? And who is going to have what kind of authority and control? Mixed signals from the President suggest that we'd like him (Saddam Hussein) not to be there, but he may well survive. And certainly at this point what we're going to do about his being there varies depending on whether you talk to the four-star generals or the President of the United States. I say that in terms of the variable impressions given, not because I know what the President wants to do. But let me suggest to you that we are giving an imprecise impression. And I think that is a question of policy that becomes important. No policy is a policy. A misread policy is also a policy, which we've seen in many different ways during the course of this crisis. And certainly the President's resoluteness, which I think was displayed admirably and well between August 2 and the day of the cease-fire, has now given way to a much less clear picture, which will affect, I think, the ultimate stability of Iraq one way or another.

The other question is the Henry Kissinger question on balance of power. I'll leave that only as a question whether or not Iraq, Iran and Syria constitute a trilateral balancing question that really needs to be addressed in a meaningful way. And then, of course, how? That will determine matters such as arms supply, economic stability and recovery issues.

In the case of Jordan, I think we have a real problem of what I would call populist politics. The King is doing probably the very thing that we would find most admirable if it were not that in doing so he came out on the wrong side of our equation. In other words, he is reacting to popular sentiment. He is acting in a populist manner. And I think this continues a trend, which was clear when he put the parliament back in place. And again, he put it back in place. It didn't spring from the internal, shall we say, ideology of the system as much as it did from the King recognizing the pressures.

And what will be the future of Jordan? What will be the future of the King's ability to control the system and certainly an economic recovery problem, which is in many respects, proportionately, the most formidable of most of the middle-range states? Leaving Iraq and Kuwait aside as very extreme cases, the economy of Jordan is at this point in disastrous shape—35-percent-plus unemployment; a lack of a resource base; a lack of remittances; and other issues.

The PLO, clearly at this point, needs to be thought of as a possible player within the equation. What do we do with Mr. Arafat and other Palestinians who are related to this equation if we're going to talk about an economic recovery based on political stability in the Arab-Israeli conflict? Certainly we're going to have to figure out where the Palestinians fit into this equation, if at all. Certainly in the short term, the PLO is an unlikely participant in the peace process.

Just this morning it was suggested that the PLO was interested in restarting the dialogue with the United States. Abu Abbas was, therefore, expendable. This may be the classical case of the PLO offering too little, too late and once again missing a unique opportunity to be on the right side at the right time, choosing instead to be aligned in a manner which ultimately has turned out disastrously.

With Kuwait, of course, and Saudi Arabia, the question is are we going to move toward democratization—I will argue that is not the right question. I think the right question is to restore the existing regimes, to restore the legitimate regimes, and, then, to raise the question of modification of political decisionmaking and political participation. I would not wait for that answer before proceeding in all other sectors. If we wait for the Saudi and Kuwaiti governments to provide an answer, for example, on growing political participation, we may be waiting far longer than we wish.

The fact of the matter is, the Saudi system remains a very closed one. We saw that indicated again this morning with this minidebate over numbers. How many people are there in Saudi Arabia? Pick a number you like and I'll find you some source that will confirm it. This is a very useful way to proceed. But the Saudi system in many respects is a closed society and there are a good many issues there that we don't really have answers to. And we're going to have to face that in the future as well.

With Melinda Kimble on the panel, I'll say only two words about Egypt, great expectations. I have never seen Egypt more expectant of future possibilities than now. I lived in Egypt in the mid-1960's when it officially went bankrupt. It made no difference. We watched them pile up debt over the years, and it made relatively little difference. President Mubarak is a legitimate ruler. There is a relative growth of democratic, participatory political life in Egypt, but I think there is also great expectations. Any time you deal with a society as poorly endowed as Egypt, with a population of a substantial size, 55 million plus, any number of achievements get divided by 55 million and the end result is going to be not a very substantial accomplishment. And I think this is going to affect, ultimately, where Egypt fits in the broad scheme of things.

With Syria, there is a major set of questions on the domestic side. Not the question of Hafez al-Assad surviving. I think he is the quintessential survivor and probably reads the coffee grounds better than anyone else in the region in terms of ensuring his own future. But the real question in his case is, is he a new ally or a retread of Saddam Hussein? We should be careful in our alignments and activiti~~es not~~ to repeat earlier errors of commission and omission. Is Assad another Hussein or has he really changed his spots? I would argue that in the short run he is a new ally who is a participant in many of the issues of the region. But we're going to have to begin to raise questions about whether or not he can deliver on some of the other issues of importance to us, most notably, the Arab-Israeli conflict, where in the short run I would suggest he is the most significant player.

Is he a new Saddam Hussein? We may not think so at this time, but there is an awful lot of popular speculation and a good deal of media coverage of the parallels between the two systems.

But there are great differences, I would argue, certainly in terms of what I would term "relative ruthlessness," a term I borrowed from the British Foreign Office. In a discussion last summer, I was told by a British diplomat that restoration of diplomatic relations with Saddam Hussein made good sense, because he had become much less ruthless. Only a few individuals had been executed without trial in 1990, compared to at least a dozen the year before. What do you call that, other than relative ruthlessness? If we use that concept, Assad is not yet Saddam Hussein.

Although there are significant parallels, I would not expect him to engage in the kind of activity we saw in the case of Saddam in Kuwait, although my Lebanese friends remind me that there was a parallel last fall. We should not forget about the fact that Syria has achieved some of its objectives there within that time period. We need to watch our "ally" with care to assure that he remains an ally and a positive force in the region.

We have all these domestic issues to deal with. They all provide questions about economic decisionmaking and political and economic recovery. Economic reform, for example, while a nice theme, is not high on the agenda of these states. Economic recovery is for some, but economic development is more important to ensure the survival of some of these countries and leaders. And that's more significant.

There are some themes of a more general rather than a statement-specific nature.

Let me simply suggest that fundamentalism is first a misnomer, but for convenience, we will employ the term. Second, it tends to be overrated. Having "lost Iran," we all tend to look for the devils elsewhere. I would suggest that fundamentalism may raise some problems and is seen by some in the region as a solution, but in most cases, the problems lie elsewhere. Certainly Iraq is not a hotbed of fundamentalism, and yet it caused for us a major problem.

At the second level, I think we ought to realize there are regional problems that need to be looked at once again in terms of providing a framework. I've always been impressed by the concept that Arab unity is one that academics love to deal with and philosophers like to write about and Arab thinkers have dealt with and Arab leaders have pontificated on. I sat in the mid-1960's through any number of Nasser's speeches where he spoke about the great Arab world and the unity of all Arab states, which, of course, he was leading.

But I would suggest to you that the myth of Arab unity is now more obviously shattered than ever before—we have two Arab leagues for all practical purposes. The GCC, I would suggest, has been modified. Instead of being a real cooperation group, it now basically functions in the security realm as the group that has had to call for external assistance to ensure its security and defense. I think that will begin to change, although it is unlikely to become self-reliant in this area. The ACC has essentially come apart. And the one great Arab union remains to be implemented in full detail only in the future. These are economic communities, but unlike the European Community, these are countries which, in most cases, have no complimentary trade, which makes it very difficult, really, for them to form an economic block of consequence.

Politically, they reflect different conceptions of what the Middle East might look like. I think we are going to see realignments throughout the Arab world, old friends and new friends. We're going to see threats. I still have grave doubts about the probability of a peacekeeping force in the Gulf, where the spearhead is going to be an Egyptian and Syrian set of contingents working side by side to ensure the relative peace and stability of those six small Gulf states. If I were one of those leaders, I would have great doubt about inviting in large numbers of Syrian and, to a lesser degree, Egyptian forces.

There is a second set of realities, the Arab-Israeli conflict, which is very much a part of this region. I will suggest only one comment as long as we are here to cover it. The realities of the current crisis have created, I think, some ways to begin to rethink what's going on in the Arab-Israeli area. But I would caution against any precipitous jumping in where it is not clear that there is a way to jump back out of the pit we're likely to get into. We should be wary of allowing our euphoria, because of the quick and positive outcome of the War, to generate ill-timed and ill-prepared initiatives that may deflect our attention from dealing with the current crisis. Every time that we have proceeded to move quickly after a conflict, we have failed to achieve any notable gains. I remind all of us that it was Anwar Sadat who set in motion the one process which did achieve a substantial positive result. And all of the others have one way or another failed to achieve major objectives.

I think in the first instance the Arab-Israeli track is likely to be far more profitable than the Palestinian track and, to my way of thinking, the notion of an international conference that might get it started, which was floated in the the New York Times this morning, is an interesting idea. And I wouldn't regard it as an unrealistic nonstarter. But if I were trying to get the economy of the Middle East back in shape and recovery established, I don't think I'd be concentrating my time on an issue of this ilk, unless there was sufficient new thinking to suggest some chance of progress.

With no time being left, I will make a very quick comment on the international involvements. And that is—do we have new players out there? I think we do have some new players that are likely to play an important role in the region. I do not regard those new players as being either the Coalition as such, which I would argue is a temporary expedient for political and military purposes, and which is likely to come asunder very quickly when it begins to get to political detail and economic reality, or the United Nations, despite its current international stature. The fact of the matter is, the United Nations remains today nothing more than the sum of its parts. And then you subtract from that, not add to it. The United Nations still has not functioned as it was envisioned in 1945. The Gulf crisis is a good example. We put together, and did it very well, and it served our purposes admirably, a Coalition of United Nations powers that was not more than the sum of its parts. It became an instrument of national policy for a number of states, most importantly the United States itself.

I think the likelihood of the United Nations being the spearhead of interchange or innovation in the region or a major player in the economic and political futures in the region is extremely slim, no matter what the major issues may be.

There are numerous other subjects to talk about. I've just highlighted a series of political questions that will provide a basis for future discussion.

Mr. WOOTTEN. Thank you, Bernard. When I asked Melinda Kimble to come over here and participate in our panel, she agreed only with the stipulation that she would be speaking for herself and not the Department of State, where she is currently employed. Melinda has excellent credentials that qualify her to help with our discussion today. She is currently working at the policymaking level in the Department of State, where she is Country Director for Egypt in the Bureau of Near Eastern and South Asian Affairs. Melinda has had considerable experience in the Department, both as a counselor-officer, an economic officer and a political counselor.

Her academic training was as an economist. She has an undergraduate degree from the University of Denver, and then advanced degrees from the University of Denver and Harvard University. With that, I'd like to turn to Melinda Kimble.

STATEMENT OF MELINDA KIMBLE, COUNTRY DIRECTOR FOR EGYPT, BUREAU OF NEAR EASTERN AND SOUTH ASIAN AFFAIRS, DEPARTMENT OF STATE

Ms. KIMBLE. I was amused to hear Bernie talk about the 50–50 rule of thumb in the Middle East, because I have used that since I took a class from John Gatch, who was one of the foreign service officers who always had a humorous story to tell about a revolution or a coup d'etat. He said when you approach a decision in the Middle East and there are two scenarios, probable outcomes are always 50–50. I found that really useful in my own work. But I decided I had to stop using it during the Gulf crisis, because Saddam Hussein used it in one of his own speeches. [Laughter.]

I believe that the economic consequences and cost of the Gulf War are not yet fully understood. Moreover, this lack of understanding, combined with expectations of a more equitable distribution of income in the Arab world, may well prove a recipe for both dashed hopes and more political instability.

Even before this crisis, the Arab world was sliding into deepening economic stagnation. The redistributive efforts of the surplus Arab oil states ended abruptly early in the 1980's as oil prices plunged. And they shifted the remaining resources to support Iraq in its 8-year war with Iran. These funds proved to be one of the worst investments ever made because they did finance Saddam Hussein's military arsenal and certainly yielded a negative return on investment.

When we look at what's left in the wake of the crushing blow dealt by the Allied Coalition, I think we have to come to the conclusion that there are not very large surpluses out there to be mobilized to reconstruct the region. Restructuring the many Arab economies in stagnation before the War began was already a daunting challenge. I believe today it will be an even tougher problem unless we have a clear idea of the obstacles ahead, some of which have impeded economic development in the region since World War II, when the beginning of the Arab state system started.

Much has been said about the renewed attention to economic development. I believe the oil rich Gulf states remember with no small share of concern the resonant chords struck by Saddam Hussein in his attempts to cast the conflict as haves versus have-nots. The dilemma at the end of this military operation, however, is that both the haves and the have-nots have substantially less reserves to invest in a region that has been experiencing some degree of economic decline throughout the 1980's. War is devastating to combatants and those in near proximity. One can easily make a back of the envelope calculation that the cost of this conflict totals between $300 and $500 billion, but the real inestimable cost is one of lost opportunity, the now urgent need to replace social and economic infrastructure that took two to three decades to accumulate, to start over, in the case of Kuwait, and to regroup in Iraq, once political stability is restored.

I have come to the conclusion in looking at redistribution issues that, just as Professor Sadowski said, it is striking when you look at the total GDP of the region, how poor the Arab states are. In 1989 if you took the cumulative GDP and divided it by the population, even if you discount the population dispute in Saudi Arabia, you would barely come out with a $1,600 per capita GDP. One can see that's not much to go on. And a lot of states would actually be worse off than they are today. There would be very little capital to invest.

A quick review of losses, the real losses and I would say in many cases nonrecoverable losses, highlight the difficult condition of the balance sheet today. Kuwait's infrastructure reconstruction costs have been estimated between $40 billion to $100 billion over the next several years. But that is no guarantee these totals will be fully expended or even that they're accurate. Kuwait continues to lose future income from the oil fires, about $87 million a day, roughly $30 billion a year. And until the fires are out, accurate estimates of future production, reservoir damage, et cetera, are impossible. Iraqi transportation, communications and industrial infrastructure have been heavily damaged. I believe it is conservative to suggest that Iraq has infrastructure losses equal to those of Kuwait.

Real GNP contractions in both Iraq and Kuwait, I would say, in the case of Kuwait you have to estimate a zero GNP through most of this year, could amount to $70 billion through the end of 1991. The regional impact of the annual GDP loss of Iraq and Kuwait, if you just say, OK, Iraq and Kuwait aren't in the Arab GDP this year, is equivalent to a 15 percent drop in per capita GDP.

What does this mean? Well, it means more austerity in many of these countries. It means more problems for governments trying to maintain political legitimacy. And when you consider that we're worried about the Soviet Union's political stability, and they're only going to lose about an estimated 12 percent of GDP this year, you can see that it portends great problems for most of the countries in the region.

Jordan and Yemen are among the early collateral victims of the Iraqi aggression. Half of Jordan's GNP was eliminated with the imposition of U.N. sanctions. Yemeni workers, in response to Yemen's open support of Iraq, were expelled en masse from Saudi Arabia, eliminating a principle source of hard currency earnings, although these workers did not lose much of their savings and have some cushion. Unemployment of expatriate labor in Kuwait has hit many countries in the region, from Bangladesh to Tunisia. Remittance losses in labor-exporting front-line states have been estimated at roughly $3 billion through the end of 1991. These losses do include savings of workers with bank accounts in Kuwait who left with nothing in the early fall. One affected country, Egypt, claims that these losses could be as high as $5 billion or $6 billion. Iraq had been severely restricting remittance transfers since 1986. And many workers from Coalition states have savings balances in Iraq that they may lose completely due to this conflict.

Tourism losses hit three countries in the region particularly hard—Egypt, Israel, and Turkey. I believe one of the greatest impacts, however, is on Egypt where tourism revenues feed the private capital market almost entirely. Inflation is already eroding current income levels in the Gulf. Press reports of government-decreed wage increases in Iraq and rapid expenditure increases in Kuwait as recovery begins are likely to add to these pressures.

Environmental damage to the entire Gulf region has been enormous due to the oil spills and the torching of Kuwaiti oil fields. The cleanup of the Exxon Valdez cost Exxon $3 billion. I believe it's conservative to suggest, if we try to clean up the oil spills in the Persian Gulf, it could cost three times that. But I think the real tragedy is it's unlikely the Persian Gulf countries will be able to mobilize either capital or political consensus to pursue a real cleanup on the scale of what we did in Prince William Sound after the Exxon Valdez.

A consequence of not cleaning up the spills may be the threat to desalinization plants along the Saudi coast and desalinization in Kuwait. And a real economic loss is the fishing industry in the northern Gulf. Moreover, we cannot easily quantify the human cost of the conflict. If as recently reported 100,000 Iraqi soldiers died, this loss, added to the tens of thousands lost in the Iran-Iraq War, could impact negatively on Iraqi productive potential for a generation.

It is important also to realize that recreating the status quo in economic terms is probably not possible. In fact, most of the real quantifiable losses, such as the oil now burning in Kuwait, are nonrecoverable. The Persian Gulf states, as I said, are probably going to be unwilling to man an environmental cleanup. Neither Iraq nor Kuwait can be fully reconstructed in the short term. The infrastructure losses will not be quickly replaced. And the high opportunity costs of the conflict, which are best reflected in precrisis GDP's of the region, have contributed to a current decline in general economic activity that would likely take a decade to restore.

The visible results of the military conflict are the damages to infrastructure. But I am more concerned about the human capital component. I do not know what this means really for Iraq in the long term. And I hope some of you will have the opportunity to comment on that.

While many people are focused on recovery, and the only comparable thing we have to look back on probably is rebuilding Europe in the aftermath of World War II, few are concentrating on the near-term economic collapse that could contribute to political instability in a highly volatile and fluid postcrisis Arab world.

Since August 2, we have seen the collapse of Kuwaiti oil production and the virtual cessation of economic activity in a tiny state with an income somewhat over $10,000 per capita.

Within the same week, we saw Iraq's oil pipeline shut down.

We saw Turkey lose its immediate source of refining fuel, and we saw Saudi Arabia also shut down Iraqi pipelines.

Kuwaiti bank accounts and monetary assets were frozen, and it is going to take a long time to sort out.

Another concern is that Kuwaiti and Iraq have long served as economic generators in the region because of their high demand for immigrant labor.

When the crisis began, some 2 to 2.5 million foreign workers were estimated to be resident in the two countries.

Many escaped or were evacuated, but many lost all their savings and possessions.

I think this will continue to impact on many of the labor-importing countries in the region.

Egypt still, today, estimates that they have 700,000 to 900,000 laborers remaining in Iraq, but these workers are not likely to be paid in the short term.

And what is more certain is their earnings will not be remitted in any near-term scenario.

I also believe that the real value of those earnings will depreciate.

By joining the Coalition, Egypt also lost the annually guaranteed transfers of savings of $600 million from Iraq which had been accumulated during the Iran-Iraq War.

These savings losses also apply to Palestinians returning to Jordan and the West Bank, and Bengalis going back to Bangladesh, and they represent in the most practical sense a dramatic loss in real income.

For the Arab countries most dependent on such remittances—Jordan, Egypt, and Yemen—we will see a likely serious economic retrenchment in the wake of the Gulf War.

In the near term, demand for Egypt's vast surplus labor pool will probably recover significantly, primarily because of Egypt's leading role in the anti-Iraq Coalition.

The recovery in labor demand, however, is not likely to materialize in time to stop what appears to be an accelerating regional economic downturn as the first shocks of the crisis ripple through the region.

Job opportunities in the scarcely populated Gulf states serve as an economic pressure valve for states like Egypt and Jordan, with thousands of skilled and unskilled youth who stood little chance of employment at home.

Their remittances have been critical to households, and these households have been experiencing a steady erosion in real domestic income on average for a decade.

The decline in general employment demand due to the destruction in Kuwait has added to unemployment pressures in these countries.

When you see the numbers of people returning to Egypt—an estimated 500,000 workers, plus their families—you find new economic costs, placing new burdens on an already severely stretched government. These include housing, jobs, schools, health care services.

These countries are not prepared and are probably going to be unable to provide services in the short term.

What has enabled these countries to maintain stability so far has been the extended family system and village networks, but I believe that sustaining them over longer periods of time will lead to more political pressure.

To contemplate the already difficult situation, we see signs of building inflationary pressures.

Saudi retail prices, as you heard Mr. Sadowski's illustration of the $27 billion Saudi Arabia has supposedly spent over the past year, are rising rapidly.

We have seen some data that suggest a 25 to 30 percent growth in nominal GNP in Saudi Arabia because of such expenditures, and most of this is leading to very severe internal inflationary pressures.

I think, as both Mr. Findakly and Professor Sadowski said, that many of the regimes have invariably resorted to printing press solutions when they have had problems.

And I see that already happening in Iraq.

Just as declining oil prices were a seemingly important element in precipitating the conflict, they are likely to be the major factor in regional recovery. The short-term outlook is not good. Stocks are high and virtually assured. OPEC's quotas may be easier to enforce as long as Kuwaiti and Iraqi production is shut down, and we could see 1991 prices around $18 a barrel.

I do not want to get into Mr. Lichtblau's speech.

Mr. LICHTBLAU. I agree. [Laughter.]

Ms. KIMBLE. But I believe too that in the next 6 months there is a chance that prices could drop more rapidly, and this would put pressure on all the oil producers and prices could remain softer than the trend, if Iraqi and Kuwaiti production comes back more rapidly than most analysts expect.

I am really running over, so rather than continue this litany of disaster, I would like to skip ahead and just let us think about what we can reasonably expect from the region in terms of capital to finance the recovery as we look at what they are working against, the backdrop of all this destruction and the need to rebuild the infrastructure, and the likelihood that their key resource which is going to finance rebuilding is going to be not really rising in price over the near term.

Kuwaiti reconstruction will ultimately be an important employment generator, but may take 6 to 9 months to get off the ground.

It is unlikely, however, that many jobs will open up on the previous scale in the near term.

Saudi Arabia may now offer some new job opportunities as they replace Yemenis. The Gulf states however may also make deliberate efforts to shift more of their foreign work force to shorter term contracts and concentrate on giving contracts to workers outside the region—to Pakistanis and Filipinos—as a means of reducing the society's vulnerability to dependency on Arab foreign labor.

The GCC will be able to capitalize a $15 billion fund if they decide to do so, but obviously this will not be enough to reconstruct the region.

Egypt and Syria are likely to continue to receive substantial grants in excess of the development fund.

But my major concern is that they will use these grants to refinance, or subsidize, their military budgets rather than for economic development purposes.

I also believe that one of the biggest problems in the region will be the shortage of capital.

Many of these countries, as Mr. Findakly said, are nonbankable, and probably Saudi Arabia and Kuwait will be major borrowers from international capital markets where they were major investors only a few years ago.

In sum, I think the outlook is not good.

I recall an article I read in Le Monde at the beginning of 1990 which I think describes the plight of the Arab World in a very succinct phrase: Le Monde published an economic summary of the problems of the Arab World, entitled "Orphans of Perestroika," and I think that is exactly where the Arab World still stands today.

Thank you.

Mr. Wootten. Thank you, Melinda.

I am sure you have noticed that all of our presenters have carefully avoided getting into any detail on the oil situation.

I am also sure that is in deference to our next panelist, John Lichtblau.

It is safe to say that Mr. Lichtblau is one of the foremost international experts on petroleum economics in the world.

He is also the Chairman and Chief Executive Officer of the Petroleum Industry Research Foundation headquartered in New York. The Foundation is a nonprofit research organization which provides analysis of public policy matters affecting the U.S. petroleum industry.

Mr. Lichtblau joined the Foundation in 1956 and became the Executive Director in 1961 and the President in 1980.

He was a contributor to the Ford Foundation's Energy Policy Project and Project Director to the Electric Power Research Institute's "Outlook for World Oil Into the 21st Century," published in 1978.

He has authored many articles on petroleum economics and has been a frequent witness at congressional hearings on energy policy, as well as a keynote speaker and lecturer at conferences and seminars in the United States and abroad, including the 1983 World Petroleum Congress.

I could go on, but I do not want to take any more of his very valuable time.

Mr. Lichtblau, please proceed.

STATEMENT OF JOHN H. LICHTBLAU, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PETROLEUM INDUSTRY RESEARCH FOUNDATION, INC., NEW YORK, NY

Mr. Lichtblau. Let me start off by saying that there is a 50–50 chance that the price of oil will go up or down, so I am covered. [Laughter.]

You know, I am an expert on oil, but not the Middle East, but the two are so hopelessly intertwined that we really need to discuss both at the same time.

The loss of Iraqi and Kuwaiti production last August was about 3.3 million barrels a day. That rose to 4 million barrels in September, and is now about 4.5 million barrels a day.

The loss was almost immediately partly offset by higher production in other OPEC countries, particularly Saudi Arabia. Even in August we already had a 1.5 million barrels a day increase in OPEC production, which offset almost half of the decline in Iraq and Kuwait.

This increased to about 4 million barrels a day—and currently the increase over the precrisis production in the 11 OPEC countries is about 5.5 million barrels a day.

So for practical purposes, the loss of oil from Kuwait and Iraq was offset starting in late September.

Ever since then, production of the 11 other OPEC countries has been as high, or recently higher, than total production would have been under the OPEC quota for all 13 member countries.

Currently OPEC is producing about 23.4 million barrels a day, which is slightly below its capacity.

We assume capacity of these 11 countries is about 24 million barrels a day.

So at the moment, the production of OPEC is determined by market forces, not by limits on supply. Probably OPEC production will decline in April. The second quarter is always the lowest seasonal annual demand. So, you are likely to see a reduction in world oil demand in the second quarter.

And since OPEC is the marginal supplier, you can assume that OPEC production is likely to go below 22 million barrels a day in the second quarter, which means there will be for the moment some spare capacity available.

The cost increase that we have seen as a result of the crisis was quite dramatic, totally.

A recent U.N. estimate had a $43 billion increase in world oil import costs over that 5-month period—August to December 1990—and about three-quarters of that went to the OPEC nations.

Now that means only the 11 OPEC nations produced the additional volumes. If you look at all the 13 member nations, of course two of them are down to zero, so the total impact on OPEC was a lot less than the $43 billion that had been calculated. But for the 11 other countries, it was that much.

As far as the United States is concerned, our average monthly oil import costs for the first 7 months of 1990 was about $4.5 billion. In the last 5 months of the year, it was $6 billion. And yet the volume of our oil imports declined about 15 percent.

So we had roughly a 50 percent increase in those 5 months in the cost of imported oil. There is no doubt this was a contributing factor to the U.S. recession.

There would have been a recession probably in any case, but the price explosion accelerated the speed of the recession.

However, the very sharp decline in world oil prices, including U.S. prices, in January 1991 may very well be a factor in a speedier recovery from the recession. So it works both ways. Altogether, it did affect our economy quite significantly.

As far as the near future is concerned, I think world oil demand this year is likely to decline slightly. There will be a lower demand in the United States partially because of the ongoing recession, and of course there is going to be substantially lower demand in the Soviet Union and most of the East European countries.

So world oil supplies are going to be adequate, if there is no new catastrophe, no new outbreak of hostilities. But there will be no spare capacity, which is a problem.

Normally you had 4 or 5 million barrels a day spare capacity which OPEC was not too happy about, but the rest of the world was very happy about because it was readily available, as we saw when the crisis broke out when we imposed sanctions on oil exports from Kuwait and Iraq.

This spare capacity was immediately made available, and it made all the difference in the world. Had it not been there, we would not have been able to put in sanctions.

If we had, we would have had to put in restrictions on consumption in many countries, particularly the United States, and drawdown our strategic petroleum reserve and so forth. But there was OPEC spare capacity and it had been there for many years, since about 1980–81. And now there is not any until these two countries come back.

As far as Kuwait is concerned, you just heard about this tremendous damage. It is not likely that any significant oil exports will take place let's say at least this year, and probably even beyond. So that Kuwait, for practical purposes, will be out of the market for the remainder of this year and perhaps part of next year, and it could be longer.

Nobody has ever seen anything like 500 oil wells burning. It is something that is absolutely unique, and everybody who is there is talking about how very difficult it is to put out the fires.

We have not started yet. We have to prepare. There are mines around the oil wells. The damage was done by real experts, not just by soldiers who were retreating. They got the oil experts in Iraq to go in there and design the maximum damage, and then they did it.

As far as I am concerned, this is a major war crime. I do not know why nobody has suggested that those who did that on purpose specifically in order to destroy something, not for any military purpose, should be held responsible.

Beyond the possibility of paying some damages, there is such a thing as punitive damages, and I am puzzled that this has not come up yet because there is an incredibly large, permanent loss of oil.

Also, of course, there is a health hazard. I talked to some people in Kuwait recently, and there is a real threat. These are things that we have to live with.

Now as far as Iraq is concerned, the southern part of Iraqi oil production has been severely damaged. The northern part has not.

So if there were no political problems, if the sanctions were lifted, you could probably export, if Turkey permitted. The flow of oil through its pipeline to the Mediterranean could reach 800,000 to 900,000 barrels a day of production very quickly.

But at the moment, the sanctions are on, and of course the north is precisely the area where there is maximum civil unrest.

So it is not clear whether this oil will be available, and how soon it will be available. Technically, it could be made available quite quickly.

Longer term, beyond the damage and the crisis, we see world oil demand rising slowly, between 1.5 to 2 percent a year, with the United States growing at a still slower rate, maybe 1 percent a year or even less depending on various legislation here with a switch to alternate energy sources and so on.

In the Soviet Union and the East European countries, you are likely to see a decline in oil demand for the next 5 years.

As far as prices are concerned, near term we see prices staying approximately where they are.

Now they could fall sharply if Iraq and Kuwait came back earlier, and if the other countries are not cutting back their production to make room for that.

This is something that everybody thought these countries would have to do when the War was over, but in fact the destruction, the sanctions, the civil war in Iraq has made it possible for them to continue producing at full scale as if the crisis had not ended.

In fact, the principal point that Saudi Arabia made at the OPEC meeting in Geneva a couple of weeks ago was: The crisis has not ended, because Iraq and Kuwait are still 100 percent out, and there is no sense discussing quotas or any return to normalcy because we are not there. And on that basis they refused to accept any kind of a restriction in quotas.

For the time being, they can continue. But if and when these two countries come back, this will be the moment of truth for OPEC.

Will they be able to cooperate? Will they cut back? If they don't, you could have a real price collapse—and I am talking about a $5, $6, $7 price drop.

Right now the OPEC price is only a little over $17 a barrel. You know that in July 1990 OPEC set a $21 price as their reference price and they reaffirmed that price at the meeting in Geneva a couple of weeks ago. Yet, the actual OPEC price is around $17, $17.50.

In other words, they are not even at the $18 price which was established in nominal dollars back in December 1986.

So that by any yardstick, oil prices are low right now, and still two major oil exporters are completely out, and nobody knows when they are coming back.

There is also the question about the Soviet Union. The Soviet Union continues to be an important oil exporter—maybe 3 million barrels a day. They used to export 4 million barrels totally to both the former Communist countries of Eastern Europe and to the rest of the world.

Then it dropped to about 3.5 million barrels, and it is probably going to be below 3 million barrels a day this year.

There has been some talk about strikes because the oil workers are so dissatisfied with their conditions. If the Soviet exports should decline sharply, there is no where right now the world could go to increase to offset the decline by increasing production.

We would have to draw down stocks. Stocks are fairly high right now outside the United States.

Stocks in the United States are low. The high stocks abroad are primarily held by producing countries, particular Saudi Arabia and Iran, in tankers and in various offshore areas. They are the principal holders of surplus stock capacity right now. They have a good reason to hold stock, because if something does happen they have these stocks to offset, to some extent, the decline in the other production; but of course it is limited.

Long term, I think there should be no reason for a sharp increase in world oil prices because once the situation gets back to normal and Iraq and Kuwait are producing again at prewar levels, there will be substantial OPEC surplus capacity.

Saudi Arabia and some other OPEC countries have actually increased their capacity faster as a result of this crisis than they would have done otherwise. They have also increased it somewhat more, and they are going to continue so that there will be surplus capacity available through the remainder of this decade. Hence, there is no need for a sharp price increase.

So it is not unreasonable to assume, if you take the 1990 average price which was very high because of the crisis, much higher than in 1989, there won't be much of an increase in the real oil prices.

We think oil prices will return to approximately their 1990 level in real dollars. However, not everybody agrees with that. The DOE forecast shows about a 2.5 percent increase in the real prices from 1990 over the next 10 years, which may not sound like very much, but cumulatively over a 10-year period it is quite a lot.

At any rate, nobody sees the kind of price explosion that we saw in 1979 or 1973; or, if there is one, it will very short-lived and we can correct it.

Now the United States is currently about 41 percent dependent on foreign oil. There is no scenario under which this dependance will not increase, none. Any scenario that says it will decline is not realistic. Whether it will increase to 45, 50, 55, 60 percent, I don't know. That depends on your assumptions. But any scenario that shows a decline from the current 41 percent to let's say 35 percent is not doable.

Now even the Administration's National Energy Strategy makes it clear that we will be increasingly dependent on foreign oil under even their scenario. And of course foreign oil means primarily Middle East oil.

So the role of the Middle East in world oil supplies inevitably will increase over the next 10 years. That is where the cheapest oil is, and it is going to be supplied increasingly from there.

This brings us to the question that we hear so often. Was this an oil war? Would we have had to go to war if we had not been as dependent on foreign oil as we were? Many people have said: If only our oil imports had been a lot lower, we would not have to send our boys to the Middle East. I question that first of all as an issue.

If a country is taken over by another country, totally illegally, without provocation overnight and the next day is said, "This is our province now," even if that country does not export anything, how can you say that does not concern us?

The other issue is: If you really just want to have low oil prices, the best thing would have been to do nothing, because Saddam Hussein invaded Kuwait precisely because he wanted to get more money from oil sales.

He had no interest in holding back the oil. He would have been happy to sell all the oil Kuwait and Iraq produced for $20 to $21 a barrel.

So it was not that our oil supplies were in danger or that the price of oil was pushed up by Saddam Hussein.

On the contrary, he would have gone out of his way to make sure that every country that wanted to buy Iraqi and Kuwaiti oil could have bought it at the price that was set at the July OPEC meeting.

It was a much bigger issue: The fact that this man, having taken over Kuwait, would have been immensely richer, and would have used his wealth to increase his armed forces, his military strength, and would have totally dominated the Middle East over time.

And this is why a country like Great Britain, for instance, which does not import any oil and benefits to some extent from the higher prices, joined the U.S. War immediately because it felt that Iraq's occupation of Kuwait was intolerable.

So I think this has to be considered.

People say that we have to reduce our dependence on foreign oil so we do not have to become involved in the Middle East crises in the future.

What can we do about it? It would take me another hour to discuss that.

I did want to suggest very briefly that the Strategic Petroleum Reserve is a very important instrument in this connection and that we ought to consider using it, refilling it very quickly, and filling it up to that 1 billion barrel target that Congress has mandated.

Thank you.

Mr. WOOTTEN. Thank you very much, John.

You all see the dilemma in moderating a conference such as this when each of the panelists could fill up the entire time on his own.

By the same token, I know we are getting near 12 o'clock and lunch. I do want to give anybody in the audience a chance to ask questions of our panelists.

QUESTION FROM AUDIENCE. I have a couple of quick ones.

THE NEW PLAYERS IN THE GULF REGION

My first one is for Mr. Reich. You mentioned that there are new players following the Gulf War in the Middle East and that we would be addressing the new security framework on a regional level, but you did not list the players, particularly those outside of the region that are now a factor.

Mr. REICH. By "new players," what I meant was that there are now a number of new players who for some time were not counted in the equation when we thought about the region, and who have an opportunity perhaps to increase their role and their opportunity to influence what goes on.

I was thinking in part about the players within the region, but outside of it I would suggest that there are new players in the sense that we have a new Soviet Union.

We have one that was different than the one that was there before.

We have a country with whom we have a different relationship than we did several years ago.

The Soviets have changed their relationship with the region, for example, by not supporting Iraq mostly during the course of the crisis.

We have the possibility of Britain and France, which have been very marginal players—especially Britain over a very long period of time—now acquiring some new-found, if you will, economic, certainly a miliary supply role, and perhaps some political clout as a consequence of what they did during the Gulf crisis.

We should not forget that, if you are talking about economic reconstruction, there are important players outside the United States despite all the contacts seemingly focusing here in the first place.

Let's remember that much of that infrastructure was in fact constructed by others, and I would remind us that the Koreans are a very significant potential factor. They have been very quiet during all of this. Never mind Japan.

I was there in November, and their economists had already calculated there was $120 billion to be made by virtue of the Gulf crisis to that point. That is even before we began to destroy Iraq's infrastructure.

So they are now thinking in terms of that. And I think we should recognize the People's Republic of China, which has been playing two levels of role in the region.

Number one, at the level of military supply, which is in nice big numbers.

Occasionally we hear about it. But also large numbers of workers, cheap labor; a good deal of textile capability, which has been an important item of sale, and I think we should recognize that we may find other states, particularly in Asia, such as Thailand, beginning to play maybe marginal roles, but nevertheless roles.

I could go through the entire Coalition, as was suggested a few moments ago, and begin to look at who played a role and what future roles they should play. They may be small players, and mostly economic, but some of them will have increased political clout.

I should remind us that the President went out of his way to talk to the Canadians, to the British, and to the French, and we tend to forget about Canada and we think of it as an appendage of the United States; they do not. They have a very different policy in this region, especially politically.

So I think those are some of the notions I had in mind. All I suggested is that this complicates the picture for the region when you try to figure out where we might go from here.

QUESTION FROM AUDIENCE. My second question was for Ms. Kimble.

THE COST OF RECONSTRUCTION AND ITS IMPACT ON ECONOMIC RECOVERY AND REFORM

You mentioned that there would be as much as $100 billion in investment specifically for Kuwaiti reconstruction, the infrastructure reconstruction, and that seems to me at least a significant amount of economic activity to be generated over the next few years as a result of that investment.

I am wondering what kind of an impact that will have on the long-term economic recovery and ultimately on reforms that we were talking about earlier.

Ms. KIMBLE. First of all, I would like to make a distinction between "cost" and "infrastructure" losses and what Kuwait is going to be able to expend to begin the recovery.

I think it is quite fair to say, look at all the infrastructure damage in Kuwait; $100 billion may not be an unreasonable figure.

Kuwait cannot spend $100 billion this year. They probably will not spend $100 billion in this decade.

They have about $100 billion reportedly in assets. If they wanted to liquify those assets, Kuwait would become liquid but all they would be doing is rebuilding their country.

I think Kuwait is going to take a pretty cautious approach.

I mean, as John Lichtblau said, you know, we have to look at the oil fields in which they are doing one well at a time.

I think the great scene was in The Post where they said, we have turned off 1, and we have 799 to go. If we do 1 a day, maybe in 2.5 years, 2 years, we will have the oil fields so they can begin producing again.

I think what Kuwait will do is they will sign some major contracts. The big one obviously has been with Bechtel to look at the oil fields. They will gradually bring back foreign workers on some kind of priority basis to do reconstruction.

It will be an important generator, but it will not become a net generator for 4 or 5 years out, I believe.

Mr. WOOTTEN. Richard, you had a question?

GULF RECONSTRUCTION IN VIEW OF ECONOMIC AND POLITICAL REALITIES

QUESTION FROM AUDIENCE. The thrust of this panel and the previous panel was one of deep pessimism about local politics and the economics of the region.

That may well be correct.

Historical analogies are always dangerous, but after World War II in Europe there was also a deep-seated pessimism.

This sounded in many ways, for reasons not all that dissimilar from what we were talking about here, deep political instability, terrible destruction, infrastructure damage, et cetera.

And yet, you know, after a year or two of problems, Europe sped ahead.

Now the situation of course is different, but perhaps there are some lessons to be learned in that, one of which is that destruction requires reconstruction, which itself is a tremendous engine of growth, and that we will have presumably in both Kuwait and Iraq.

The other possible analogy is that terrible mistakes from war's destruction and economic decline in some cases can generate a major rethinking within the region of mistakes made in the past, so that the future is not always straight-lined from the past and therefore we could have net sets of policies different from those that have worked in the past.

The third question is external finance.

People have talked about the capital shortage of the region being fixed.

That would be different from Western Europe where the Marshall Plan pumped in a lot of money, and that is apparently not on the horizon.

However, it may be that it is precisely the shortage of capital which is what the region needs, because in the 1970's and 1980's, as we all know, there was tremendous wastage and inefficient use of capital.

Maybe it is precisely a capital shortage which is what would force economic reform, better economic policies, and eventually economic development.

Mr. **WOOTTEN**. Before you answer that, I know that Richard has a question similar to yours and I will let him ask it now, in the interest of time.

Mr. **KAUFMAN**. In light of the fact that the Coalition led by United States conducted a war that resulted in the worsening of the economic situation, what is the responsibility of the Western members, and in particular of the United States, in this postwar reconstruction period?

Mr. **WOOTTEN**. Let me say, first of all, in fairness to our afternoon panel that we are going to get into that in some detail.

I am not trying to cut off the question at all, but I just want to point that out to all concerned.

Having said that, let's go to Mr. Reich first.

Mr. **REICH**. Since you are raising political issues mostly, let me just make a couple of observations.

I firmly believe that what we ought to do is give General Schwarzkopf a fifth star and have a Schwarzkopf Plan for the Middle East, which would be the functional equivalent of the Marshall Plan.

The problem is, by quick calculations someone the other day suggested to me that if we take the same amounts of money and the same vision that we had after World War II, we are talking about hundreds of billions of dollars to do the functional equivalent of what was done then.

I don't know the exact numbers. I will leave that to the economists. But let me suggest to you that the real reason why we tend to be pessimistic is I think the situation in the Middle East is very different from after World War II.

After World War II, a lot of countries were destroyed. A good deal of infrastructure was destroyed. A good deal of delegitimization took place. But much of the area at least was prepared to cooperate with each other, if you will, to put it all back together again.

What I suggested, and what I think others have suggested before me, is that when it comes to the Middle East we have to remember that it is not simply a matter of reconstructing the economies of this area, but an overlay on top of the existing set of problems which have been around for some 40 years plus.

The Arab-Israeli conflict is one. The Arab-Arab conflicts are another.

All of which are superimposed on top of political regimes which do not have the same kind of, shall we say, sense of dynamism that the European states did, nor the sense of cooperation that was there.

We do not have that external great vision and leadership that is going to be essential to put all the pieces together.

In other words, it is not World War II. It is not an analogy to that.

I do not think the situation is hopeless, but I think the assumption that, because we had a war, suddenly everything becomes possible that was not before is a highly problematic assumption; that we could solve the Arab-Israeli conflict tomorrow and get the haves and have-nots together, and suddenly get democratic regimes where they have not even thought about it before, and try to get it to work, are subjects I think we have to examine very carefully.

I would like to separate the economic recovery from the other part.

And by the way, Norman Schwarzkopf has not proposed such a plan, and he knows enough about the region to recognize that he will never get it funded by Congress.

Mr. WOOTTEN. Did you want to add something to that, Melinda?

Ms. KIMBLE. I think it is quite possible we will have some deep-rooted thinking about how economies are managed in the Middle East.

But, paradoxically, I think you are most likely to see the rethinking in Kuwait and Saudi Arabia and the GCC.

I think over the longer term, being in the capital markets, just as we thought junk bonds would do, I think this will have a disciplining effect on these countries.

However, you still have the problem of the countries with demographic pressures, particularly Egypt, but I think it is also true of the West Bank and Jordan where it is unlikely they will be able to stabilize and restructure the economies without massive losses in income in the near term, and governments will find that politically impossible to cope with.

Mr. WOOTTEN. Another question?

QUESTION FROM AUDIENCE. I guess this is for Mr. Reich.

WAR REPARATION FROM IRAQ

How do you expect the debate over war reparations from Iraq to play itself out in regional politics in the Middle East?

Mr. REICH. I know how I would like it to work out. [Laughter.]

Mr. Lichtblau I think raised a very critical point.

We are forgetting in all of our recent discussions that there were war crimes committed; that there were sufficient acts that require not only reparations in kind, but also punitive damages to be assessed.

I noticed that in all of our discussions today no one has addressed that question, above and beyond simply putting everything back together again.

But I have a bill for Saddam Hussein as well. My guess is that we are going to find that much of that is going to disappear in the background.

The Kuwaiti Ambassador the other day suggested that even the Israelis had the right to submit a bill.

I would like to see what happens when it is submitted. I would like to suggest that much of this is simply going to disappear.

But I think we will have, as one of the things that is pushing it, something of a fund to be assessed on Iraq to be paid out of oil revenues.

This is part of the Security Council Resolution now being discussed.

My guess is that there will be an attempt to show some punitive damages being assessed on Iraq so that it cannot get away with what it did.

In other words, I do not believe that the argument that simply because Iraq has been so badly destroyed we ought not to inundate it with all kinds of other requirements that will cause it to come apart and then we will have instability and lose the balance of power, and so on, is going to prevail with some of the very strongly anti-Iraq sentiments that have been developed during the course of this War.

When the damage is fully assessed in Kuwait, when the damage in Saudi Arabia and elsewhere is looked at carefully, I think there is going to be strong sentiment to be sure that Iraq pays something, and to understand that this is the kind of action that is not launched again.

I would like it to go as far as Mr. Lichtblau's suggestion, which is to really get to the point of looking at war crimes. I do not think that is politically feasible or likely.

Again, the parallel to World War II is not there, although it has been suggested any number of times.

One additional observation. I have adopted the broccoli principle for this War. Early on in this crisis I wondered to myself what would have happened if Kuwait's principal export product was broccoli instead of oil. Would we still have gone in? Would we still be thinking the way we do?

Because this commodity is so central to what is going on now and will be in the future, as Mr. Lichtblau very ably pointed out, I think we are going to think about all the ramifications and we will begin to make some political decisions, and that is very much a part of your question.

We are going to be worried about that lack of surplus capacity. We are going to be worried about the prices. We are going to worry about these countries coming back on line, and we are going to factor that into any decision made with regard to such things as punitive damages.

Mr. WOOTTEN. Richard Kaufman wants to ask a question, and that will be the last.

OIL PRICES

Mr. KAUFMAN. For Mr. Lichtblau, and it relates to this commodity of oil and its price.

Obviously if the price is too low it makes it impossible for the countries in the Middle East to do anything for themselves.

If it is too high, we saw already what happened in the fall to the U.S. economy and to others.

Is there an equilibrium price that would facilitate some self-help in the region and make it possible for growth to continue?

Mr. LICHTBLAU. Of course. Yes, there is.

But everybody has their own equilibrium, and they do not necessarily all jibe.

However, there seems to be a consensus of views currently around the $18 to $22 range.

And of course the price, the equilibrium price is different for a country like the United States than it would be for a country like Japan.

Japan imports all of its oil. The lower the price, the better they like it because it reduces their energy costs.

We still produce 55 percent of our oil domestically and have a very large domestic industry. At $13 or $14 a barrel, our industry could not survive.

We would have to put on import fees or some restrictions.

So at the $18 to $22 level, I think the domestic producers could survive.

Incidentally, there is a difference between the U.S. price and the OPEC price. The two are sometimes confused. The OPEC price is generally $2 to $2.50 lower than what we call "West Texas Intermediate," the U.S. reference price, because of freight and quality differences.

So when OPEC talks about $21, it means $23 for the U.S. prices. So I think that the $21 is likely to be accepted by the United States.

There has been a lot of talk that now that we have done so much for Saudi Arabia we will influence or tell them what the price of oil should be. First of all this is extremely sensitive in Saudi Arabia.

As soon as somebody even suggests it, the Saudis get up and make statements, as they did recently, against the President of OPEC who did suggest this in a speech just before the last OPEC meeting. Saudi Arabia actually asked for his resignation because at an OPEC meeting he had made a suggestion that Saudi Arabia is carrying out U.S. oil policy.

Not only do the Saudis not do so, but there is not much of a difference between the interests of the two countries.

There is a coincidence of views. People here like to see the price in the low $20 range, and so would Saudi Arabia, and so would most of the world.

The idea that prices should be as low as possible when we are talking about energy conservation and alternate energy sources for environmental reasons goes against that whole policy.

So I think that most of Europe would accept that range, too, and even Japan.

Because Japan does not want to see very low prices which then make their nuclear power plants unattractive economically, and so on.

So I think that is a price that is acceptable possibly, even though it is not based on any scientific calculation.

Mr. WOOTTEN. Thank you very much.

I want to thank the entire panel—Mr. Reich, Ms. Kimble, of course, and Mr. Lichtblau. Their presentations have set the stage very well for this afternoon's panel.

I invite all of you to come back at 1:30 p.m. We will try to start right at 1:30 p.m. and be finished at 3 p.m.

Our presenters this afternoon will be Richard Feinberg, who asked that very provocative question just a moment ago, and

Fareed Mohamedi. Together they will get into some of the specifics about reconstruction in the Gulf and the costs.

Then we will finish up with John Steinbruner, who will take on the extremely complex problem of arms control.

Thank you, very much.

[Whereupon, at 12:05 p.m., the meeting was recessed, to reconvene at 1:30 p.m. this same day.]

AFTERNOON SESSION

The workshop was reconvened at 1:30 p.m., by Jim Wootten, Congressional Research Service, Library of Congress, and Richard F Kaufman, Joint Economic Committee, co-moderators.

OPENING REMARKS OF JIM WOOTTEN

Mr. Wootten. Welcome back to those of you who were here this morning, and welcome to those who just arrived. I will try to limit the panelists' remarks so the audience will have an opportunity to ask questions; a very important part of the overall program.

But first, I think Richard Kaufman has something he would like to say.

OPENING REMARKS OF RICHARD F KAUFMAN

Mr. Kaufman. First, on behalf of the Joint Economic Committee and the Chairman, Senator Paul Sarbanes, who is here with us this afternoon, welcome to the afternoon session. Second, I want to ask if Senator Sarbanes would like to make a few comments about why he requested this workshop.

I should point out that one of Senator Sarbanes' predecessors on the Joint Economic Committee, Senator William Proxmire, is in the audience with us. So we are assured of having very provocative questions for this panel.

OPENING STATEMENT OF HON. PAUL S. SARBANES, CHAIRMAN, JOINT ECONOMIC COMMITTEE

Senator Sarbanes. I will be very brief.

I am sorry I was not able to be here in the morning. I am going to listen to the statements, and then I may have to depart, but knowing that Bill Proxmire is here makes that easy because I know that he will put the panelists through their paces, to put it mildly.

Bill, it is nice to see you. The Committee prospered under his Chairmanship for a number of years, and I am delighted to see him here.

I will just be very brief. We welcome this opportunity to join with the Congressional Research Service in jointly sponsoring what I think is a very important workshop. Obviously it is very timely, and it is very relevant to the policy agenda.

We have over the years had a very close and productive relationship with the CRS. This is but another manifestation of it, and we welcome that relationship.

I simply want to express my own commitment to it, again. I think obviously it needs no elaboration from me to underscore the importance of this workshop and the relevance of the matters that are under consideration.

I am particularly pleased at the quality of the panelists who have agreed to participate. I am very pleased to join all of you in this afternoon's session.

Thank you. Maybe I will come down here and just grab a chair.

Mr. WOOTTEN. Thank you, Senator.

This afternoon we are going to get into the actual task at hand, which is reconstructing the damage done both during and prior to the War.

After that, John Steinbruner will talk about arms control issues in the area.

As I said this morning, the economics and politics of the area are so intertwined that it is impossible to talk about one without the other.

We are going to start out with Richard Feinberg, Executive Vice President and Director of Studies at the Overseas Development Council where he has co-authored studies on the World Bank, the International Monetary Fund, and on economic reform in formerly Socialist countries.

Richard served as the Latin American Specialist for the Policy Planning Staff for the Department of State from 1977 to 1979. He holds a Ph.D. in economics from Stanford University, and has worked as an international economist for the Treasury Department and with the House Banking Committee. He is also an Adjunct Professor of International Finance at Georgetown University's School of Foreign Service.

I could go on, but again in the interest of time, I am going to turn it over to Mr. Feinberg.

STATEMENT OF RICHARD FEINBERG, EXECUTIVE VICE PRESIDENT AND DIRECTOR OF STUDIES, OVERSEAS DEVELOPMENT COUNCIL

Mr. FEINBERG. Thank you very much.

I will make some general comments about economic development problems and experiences in other parts of the Third World as they might be applicable to the Middle East.

I will also make some comments on the specific problems of reconstruction in the areas that have suffered severe civil and military conflict, and some of the lessons that we may cull from those experiences and apply them perhaps to the Middle East, always recognizing that making political analogies is a risky and a dangerous thing.

I will be making vast generalizations. We all will be able to point out one or two countries in which my generalization does not apply absolutely. I accept all that. Therefore, I maybe have been crazy to take on this assignment in the first place.

My first point would be, I do not pretend to be an expert on the Middle East, but I have done some reading on it for the last few months. What is striking is the militarization of studies of the Middle East.

For every study one can find on the economics of the Middle East, there are 100 different studies of arms transfers, Palestinian rights, West Bank, et cetera, which is not to say that those are not important issues, but there has been a tremendous imbalance. Therefore, I congratulate the CRS for holding this conference, just to try to put some focus on the social and economic problems which are, after all, so severe in the region.

In looking at economic development as it has or has not proceeded in the Middle East over the last couple of decades, a point that was stressed by some people this morning is the lack of success—despite all the resources. There is a general feeling, including in the region, of failure and a decline particularly in the 1980's.

There is increasing recognition, certainly by analysts in the West but also in the region that radical socialism has not worked—excessive statism has been detrimental; moreover, the effort to play big power politics through alignment with the Soviet Union also did not work, either in terms of the types of weapons systems that were delivered, or the economic advice and equipment.

At the same time, efforts at Pan-Arab regionalism have proven largely futile. Regional trade was a false solution, and there is a tremendous diversion of energy, intellect, and resources that is going into anti-Israeli activities, which has resulted in taking away efforts that are critical as far as economic development.

Now a lot of these mistakes were made in other parts of the Third World, as well. One sees in Latin America, as well as parts of Asia and Africa today, widespread self-criticism of past policies and an effort to undertake new sets of policies. This has been tremendously beneficial to economic policy in other parts of the Third World over the last several years.

We are beginning to see that sort of domestic self-criticism in the Middle East, not to the same extent as elsewhere because of the special problems in the Middle East, but it no longer comes from the outside. When and if it does come from the inside, we should perhaps stimulate and catalyze it through analysis, as that would be very beneficial.

To that extent, by the way, economic decline can have its silver lining. Economic decline has preceded now in Egypt for 20 years, and in the Gulf states for almost a decade—catalyzing a rethinking, self-criticism, and eventually, hopefully, new policies.

The extent to which there is a capital shortage was emphasized this morning, because of stagnant oil prices and other problems. That is good, not bad, in terms of promoting economic reform. Because if there is a lot of fat, who is going to worry? We are doing fine. But when there is an economic squeeze, it causes people to rethink policies. That may take several years, but they have been having problems for several years now, and this situation may arise.

There is a need for adjustment in the region not just because policies have not worked very well, but for the same reason that there are adjustments going on in China, India, the Soviet Union, and the United States itself, because global markets, technological change, global competition, et cetera, is forcing change in every country in the world today, and is forcing us to adjust, as well.

You can be sure that it is going to force Egypt, Jordan, and Syria to adjust, because they are much more vulnerable and they have fewer choices open to them than we have. So there is tremendous pressure, really, for adjustment. These pressures arise from domestic experiences of unhappy efforts in the past that have not panned out, as well as from these external global trends. So we will see eventually reforms of rethinking of the role of the state, rethinking of the role of monetary policy and exchange rates, how to price agricultural products, all of which will need to be dealt with.

This morning there was some hint in the discussion that the alternative is reform versus development, and that somehow of course everybody would prefer development if they were not going to do reform. That is not the choice at all. Assuming what I am inherently saying in my analysis is correct, if they do not undertake reform they will not have development.

The opposite of reform is not a good living standard. The opposite of reform is continued austerity and decline.

So it is not somehow by responding to reform that the regimes in power are assured a political future.

It is quite the opposite of that. If they do not reform, their political future will be in jeopardy.

This brings me to another issue: The relationship between economics and politics in the reform processes as viewed throughout the Third World.

There is a very rich experience from Africa and Latin America, and I cannot go into all of it now, but let me just draw one hopeful lesson.

We used to think back in the 1960's and 1970's during the age of realpolitik and all that, that only authoritarian governments could implement deliverable reform. The rationale behind that was that you needed a strong arm, a strong state to overcome the vested interests that have to be broken in order to push through good economic policies. This could only be done by an authoritarian state—that was the old thinking.

But with experience we have found that in fact a lot of authoritarian regimes turned out to have very lousy economic policies. They could be very corrupt. They could be just as soft. They could be just as vitiated with special interests as democratic regimes. So authoritarianism is no guarantee of good economic policies.

Conversely, we have seen experiences in which liberal, open democratic governments have successfully brought about economic reform; that liberal democracy and good economic policy are not at all inconsistent in the Third World.

We can take that as assumed in the industrial world, but also in the Third World. We are seeing in Latin America today precisely the sort of governments that come in with a very broad base of popular support, including from middle and working classes, that now are implementing very tough economic policies that take on vested interests in business, in unions, in the bureaucracy, et cetera, and are pushing them through.

Why are they pushing them through? Because they see that the economic reforms are the only hope for the stability of their regime, and even their ultimate political success, looking down the road 4 or 5 years.

So that is very helpful, and it is hopeful I think as we think about the processes of political liberalization and economic reform also in the Middle East.

Now, just to show I am sensitive to the special problems of the region, there is a special problem with Islam upon which I do not in any way pretend to be an expert. There are those in Islam, as there are in any big religious movement, with authoritarian tendencies, and those with democratic tendencies. That does not mean that you should automatically assume that the authoritarian tendencies will always necessarily be the dominant ones.

From the little bit I know of the situation in Egypt, for example, some of the Islamic movements in fact are not of the authoritarian variety, at least in their rhetoric. Also, Islam should not be seen as incompatible with capitalist markets. There is a strong tendency in Islam which in fact justifies markets. So we should not automatically assume that Islam will result in autarchy or some sort of extreme form of socialism.

There is, though, in Islam, I think a very serious problem, however, which is the problem of gender. This I think is a very serious, difficult problem as far as liberalization goes.

To my mind, one of the major explanations for the growth of an authoritarian fundamentalism in the region is the intent to put women back into their traditional roles. There are a lot of forces creeping through the region: Modernization; cosmopolitanism; people traveling; the situation of the labor markets—all of which would normally result in a greater role for women in society, which is antithetical to what many Islamic men want.

Therefore, the effort to push women back into the old roles pushes the men toward authoritarian fundamentalism. I think that reality lies behind a lot of what is going on in the region. This tremendous conflict is something which makes the region essentially different from most regions in the world.

In any case, political conditionality in general is going to be more important in international lending to the region than it was in the past. As was mentioned this morning, ultimately our bluff was often called when we advocated economic reform or even political reform.

Ultimately the regimes could say, look, don't bother us. Go to the Defense Department. Go to the National Security Council. What they really care about is us, our stability, our foreign policy. Don't talk about economics and domestic reform. They would call our bluff, and they would call it successfully.

Maybe they will continue to do that, but one variable they were always able to play is no longer there, which is the Soviet card, with the end of the cold war.

Presumably, our tremendous fear of change—that it would be exploited by the Soviet Union—should no longer be as strong. We should be more willing to risk change, and even favor it, then we were in the past because it will not be exploited at least by the Soviets.

Perhaps there are other forces out there we might worry about, but at least that Soviet element is not there.

We also have seen that the long-term security effect—of ignoring sound principles of economic development—is bad for American policy.

So putting all that together, it seems to me there is more of a chance—and now with less money available we need to ration the amount of money that is there—that we will condition our and other countries' economic flows, capital flows, on good economic policies and perhaps at least some minimal degree of good governance.

"Good governance" can be minimal in the sense of not tolerating massive corruption, if that is as much as you think you can engineer in one country at any given time, or "good governance" can imply moving toward different levels or degrees of political liberalization.

There is also the question, which I am sure John Steinbruner will address, of military spending and its impact on economic development.

Those are just some of the lessons that one could call upon in looking at what we have picked up from other parts of the Third World and the experiences of the last 10 years and how that might apply to the Middle East.

Let me touch now in my remaining 5 minutes on the issue of reconstruction. What can we cull from other efforts at reconstruction?

I will talk a bit about Europe after the War, and then I will talk a bit about this book that ODC put out recently. I know you have all read it, of course; it is called "After the Wars," edited by Tony Lake, which looks at the situations in Central America, Afghanistan, Southern Africa, Southeast Asia, regions that have had severe conflict over a long period of time, and how might we think about the reconstruction, political and economic, of those regions?

So these are tough issues.

The Marshall Plan: I realize there are tremendous differences, but still there are perhaps some things from which lessons can be culled.

On the issue of pessimism versus optimism, there was tremendous pessimism in Europe after the War, just like there is in the Middle East today. But that can perhaps be overstated. If we see the problems of the past without seeing the opportunities of the future, it may not be however that the Marshall Plan is necessary, but rather an anti-Marshall Plan may be precisely what the region needs, or a capital shortage, in order to spur reform at least in the initial phase. Then you bring money, once reform is underway. So a capital shortage may be good rather than bad.

Well, there are some other lessons in the Marshall Plan. Countries in the region, at least portions of government in the region, have to be committed and have to be involved. They have to do it themselves—that is, local initiative. This is something now in 1991 that we recognize as critical throughout the Third World.

It was true in the case of Western Europe, as well. This does not mean that every governmental ministry, that everyone has to be in favor of it, but there has to be a core of people that you can bet on and work with and allow them the initiative to go forward.

A second lesson from the Marshall Plan is that you have to have good macroeconomic policies. If you do not have good macroeconomic policies, you do not have efficient investment, public and private. The investment that goes in will not be invested efficiently, because the price signals will be off.

So you have to have a good macroeconomic policy. That does not mean, in my view, that you still cannot build some good hospitals, some clinics and schools. That can still work, even if there is inflation and fiscal imbalance. I think some people argue that. You can still do some things. But if the economy is really going to go forward, you need good macro policies.

Then there is the issue of regionalism. The Common Market was not built overnight in Europe. Remember it started slowly with building blocks. We also need that as an approach that we might take toward the Middle East.

Look at certain sectors. We have water, for example. Work on that, and proceed sector by sector. Outside donors can, if they have a clear vision, overcome some of the parochialism that is inherent in nation states, and stimulate a gradual movement toward regionalism.

Those are a few lessons from the Marshall Plan.

Now, Third World conflicts. What can we learn? Consider five lessons we might draw from the experiences in other parts of the developing world.

First, if you walk into a country that has been devastated and you go around and just ask people what needs to be done, they will give you this long laundry list of 12,000 things, and that is how you get up to these insane figures, it seems to me, that says it will take $100 billion to reconstruct Kuwait.

Kuwait is a medium-sized city with 600,000 citizens; $100 billion? I do not understand where these figures come from.

Anyway, you cannot just catalogue this long list of needs. You have to cull through it carefully and set priorities. Prioritization. That will be key. The locals may have trouble doing that, because everyone wants their items on the list. That is where outside donors can come in and at least help the planning ministries or ministries of finance to think through what the priorities are, with what is most important and what should be done first.

The second lesson—taken from other regions of the world—is that it is often an issue not of reconstruction but of construction. After World War II in Western Europe, for example, the destruction of factories which were inappropriate in the first place, or outmoded in technology, was a blessing in disguise.

So in Kuwait hopefully we are not going to rebuild all those palaces that made up the suburbs of Kuwait City. It is not a matter of reconstructing the old, but rather constructing something that is more appropriate to the 1990's in this case.

A third lesson which we mentioned this morning has to do with the question of absorptive capacity. In some countries, absorptive capacity may be very low. We cannot really get things moving until you build minimum absorptive capacity. What I have in mind here is infrastructure, the base of communications, transportation, et cetera, which we have successfully and perhaps unnecessarily blown away in good portions of Iraq. So some of that will have to be put back in to get things moving.

Then there is the issue of human capital. This would hold true in some of the poorer, less-developed Arab states where you have got to have a core of technicians and, of course, economists and political scientists, et cetera, to form that core group of people.

Then the fourth point. This was emphasized I think correctly this morning: The political economy of adjustment. You cannot have political programs that ignore economics. If by "politics," one means you put together a coalition just so you have 51 percent of the vote, and can say, "that is terrific and that is what we are looking for." But if that political coalition does not have an economic policy which is reasonably coherent and viable and has some sense of development, it will fall apart in a couple of years anyway.

So you need a political economy approach to development. This should not, however, result in stagnation, or the idea that the status quo is the only thing we can do. Every government is very fragile and it is difficult to move forward, because actually I think what one has seen in other parts of the Third World is that a bold economic program, properly supported from abroad, can in fact be successful in the sense of being both politically popular and politically sustainable.

If the population has witnessed economic stagnation and decline for a long enough period of time, which I think is the case in some of these Middle Eastern countries, they are going to say, yes, we will take economic reform and we will go with it.

The alternative to economic reform is not a good life, but rather continued decline, and they may be willing to take a small amount of inflation and belt-tightening in order to get over that hump and move forward. That will vary from country to country, but I would suggest that bold political leadership can make that work. We have seen in Eastern Europe how that may work, as well, in efforts to move in that direction.

So lessons would include: Prioritization of your investment program; in some cases at least we are talking about not reconstruction but construction; creation of greater absorptive capacity; and we have to have politically sensitive economics.

I would just add one last idea. Anything you do in the economics area should be done on a multilateral basis, not only because we do not have the money to put up and expect someone else to finance—the "burden-sharing" argument so popular here on the Hill—but also because multilateralism gets you maximum political leverage and also gives you more legitimacy to push for various economic reforms.

We were fabulous in building that multilateral Coalition for the purposes of fighting the War in the Gulf, and I would hope we could stand on that wicket as we approach the economic problems of the region.

Thank you.

Mr. WOOTTEN. Thank you very much, Richard.

We will move on to our next presenter, Fareed Mohamedi. Fareed is a Senior Economist at the Petroleum Finance Company, Ltd.

Prior to joining that company, Mr. Mohamedi was an economist at the Institute for International Finance. He worked before that at Wharton Econometric Forecasting Associates for the Middle East and served as a consultant to the World Bank, West African Department.

Before Wharton, he spent two years at the Ministry of Finance in Bahrain as coordinator of all economic research conducted by the Ministry.

Mr. Mohamedi received his Master of Arts from Georgetown University Center for Contemporary Arab Studies.

His degree was in Middle East economics, and he holds a Bachelor's in Economics from Western Michigan University.

Mr. Mohamedi, please proceed.

STATEMENT OF FAREED S. MOHAMEDI, SENIOR ECONOMIST, THE PETROLEUM FINANCE COMPANY, LTD.

Mr. Mohamedi. I am basically going to dance around the edges because I think most of the major issues have been addressed, and very aptly.

Anyhow, as with major conflicts in history, the Gulf War is likely to be a watershed in terms of Middle East economic development. The War has proven to be a major disaster for the region and disrupted whatever semblance of stability there was before August 2, 1990.

It is now clear that future growth and income distribution depends on a far-reaching transformation of the fundamental structures of the economy.

Whether this will occur with the desired effect of putting the region's economy on the path to a better future is still unclear, but the general direction of change is almost assured for two reasons.

First, the process of regional disintegration seen in the post-1986 period will now intensify largely as a result of the expected decline in Gulf aid.

Second, the external pressures mainly from foreign creditors to reform the economic structures will be complemented by internal demands from the Middle East.

The oil revenue-aid-external-debt-financed development plans of the last few decades are essentially unsustainable. This is as true for the Gulf as it is for the rest of the Middle East.

It is against this background that the issue of reconstruction has to be addressed. In dealing with this issue, I will concentrate more on the process of reconstruction rather than specific costs. Some of the damage assessments are so huge that the sums are extremely difficult to comprehend.

Let us start with Kuwait.

In my opinion, the issue of the reconstruction of Kuwait cannot be separated from the political changes that are likely to take place during the next several years.

I expect that the major goal of the democracy movement over there will be to put the economic policymaking under the control of a newly established Parliament.

That immediately raises the issue of the royal prerogatives. Foremost on the agenda will be attempts to scrutinize royal stipends.

In all the Gulf countries, royal families initially allocate a substantial amount of oil revenues to their own members. That allocation process depends on the family members' ties, either familial or factional, to the main group in power. Therefore, an attempt to reduce the amount and control the direction of funds effectively reduces the ruler's power.

In Kuwait the democratic movement will question the right of the royal family to receive these funds and attempt to curtail the amounts, and thereby strike at the heart of the royal prerogatives and power.

On a more secondary level, the democratic movement will push to take control of the budgetary process. Given these aims of the democracy movement, the royal families' current plans to rebuild the country have already drawn two major criticisms.

First, the overwhelming use of certain contractors prior to formal bidding procedures, and especially the use of contractors of a particular country.

This also reflects wider fears that the royal family will compromise general economic policy under pressures and obligations emanating from the War.

Second, the method of financing: Whether reconstruction will be financed from existing foreign exchange reserves, or from borrowed funds.

This is part of a more general debate on who will ultimately control foreign exchange reserves.

The democratic opposition fears that royal control of the assets at present will be used as leverage over the opposition to force them to tone down their political demands. Therefore, if demands by the opposition to wrest control of the budgetary process go too far, the Al-Sabah may refuse to release funds for reconstruction through asset drawdowns and push financing onto bank borrowing. This will undoubtedly impose a huge burden on the future fiscal accounts.

Now to Iraq and reconstruction issues in Iraq.

The Allied air war waged against Iraq has crippled its economy through the systematic destruction of its basic infrastructure and much of its productive assets. Estimates of the damage range from about $100 to $200 billion, depending on the method of calculation. More importantly, the Allied attacks destroyed much of Iraq's foreign and domestic income-generating capability.

Given the highly urban nature of Iraqi society, where nearly 50 percent of the population live in two major cities, Baghdad and Basra, the bombing campaigns and the civil war that is presently raging has rendered the bulk of Iraqis who are not farm workers unemployed and without a stable source of income.

We already see the economic effects of the War in spiraling inflation, and the ultimate debasing of the Iraqi dinar. In fact the next phase of the process, which most probably has already occurred, will be the total abandonment of the Iraqi dinar as a medium of exchange, and a reversion to barter or the use of foreign currencies, smuggled or saved.

Those possessing no access to hard tradable goods or currency will fall on extremely hard times, possibly to the point of being unable to buy food.

To break the vicious cycle described above, the Iraqi Government will have to restore oil production and exports.

Given the current state of upheaval in Iraq, I cannot foresee an immediate resumption of oil exports either through Turkey or

Saudi Arabia. Exports to the north depend on the Iraqi Government regaining control of Kirkuk and the rest of Kurdistan.

Moreover, given the Turkish Government's recent statements against Saddam it is highly unlikely that there will be reconciliation which will lead to use by Iraq of the Turkish pipeline.

Exports through the south depend on U.S. withdrawal, rebuilding some oil facilities and reaching some accommodation with Riyadh. This is a process I cannot see being completed by 1991.

While assuming this happens by 1991 or 1992, we can say that the export volumes may average about 700,000 barrels a day by next year. At an average export price of about $18 a barrel next year, total exports could reach no more than $3.65 billion.

Constrained to this level of exports, Iraq is unlikely to be able to purchase much more than basic food items for its population.

Even with the restoration of full production capacity, which is unlikely to materialize without technical and financial assistance from abroad, Iraq is essentially only going to be able to purchase basic necessities and imported refined products.

The commencement of major reconstruction activities, especially of infrastructure, will depend on a number of factors.

First, a comprehensive settlement with the Coalition members has to be reached on the release of Iraq's external assets, which at the time of the invasion totaled $3.3 billion.

I know there has been a lot in the news lately of the President's private sums. I expect these sums, plus whatever else has been uncovered recently, to be used as reparation payments.

Second, if Iraq can secure future bilateral and multilateral credits, its external financing constraints may be partially alleviated, but this will be contingent on Iraq successfully concluding an agreement with the IMF to establish a macroeconomic stabilization program and a major structural adjustment program.

Simultaneously, the Iraqi Government will have to enter into negotiations with external creditors to settle outstanding claims incurred in the 1980's.

Official creditors, excluding the Gulf countries, will insist on comprehensive rescheduling settled through the Paris Club.

With external debt outstanding at the end of 1989 at about $35 billion, the bulk of which is to bilateral sources, debt service payments can reach about $2.5 billion per year even with the most generous of terms.

Third, it would be impossible for Iraq to reestablish a reasonable level of economic activity if debts to the Gulf countries are not canceled. That's a big question.

Let's turn to the rest of the Middle East. The poorer countries of the Middle East also will be coping with their own attempts at picking up the pieces after the Gulf War.

This is because Gulf aid and employment policies are likely to become extremely selective and conditional. The selectivity will be based on three conditions.

First, all outstanding debts arising out of political and military help given during the current crisis will be settled. Therefore, Egypt, Syria, Turkey, and Iran are likely to receive aid promised during the early days of the crisis.

This will come in the form of debt writeoffs, low-priced oil sales, and direct cash grants.

The bulk of these obligations have already been settled and will not yield the recipients much more in significant funds.

Second, during the next several years, aid flows will be primarily made from the Gulf to bolster members of the new security alliance that will be established.

The Gulf Cooperation Council has already established a $15 billion fund for economic assistance partly for this purpose.

Remittance from the Gulf countries has also served the function of aid. As a result, Gulf countries import about 50 percent of their foreign guest workers from other parts of the Arab world.

The policy of selectivity will also rule in the use of foreign workers where workers from countries who were officially hostile to the Gulf in the recent conflict will be actively discriminated against.

As a result of the fall in bilateral aid from the Gulf and the need to supplement this aid with more permanent, productive forces, I believe this will require the establishment of a new system of aid in the Middle East.

I believe the appropriate mechanism for disposing external capital flows will be a multilateral institution along the lines of a regional development bank.

First it would require relatively little capital to establish such an institution, and the bulk could come from the Gulf countries.

With the industrial countries' official presence, such a bank could leverage its capital, borrow from international capital markets, and channel long-term development funds to the needy countries of the region.

This self-financing function would alleviate the need to constantly channel aid transfers to the problem countries from the Gulf or bilateral donors in other parts of the world.

Second, the bank would ensure that the funds lent to the government would be used for productive purposes, something bilateral lenders have not been able to do in the past.

This could also ensure that the region avoids reconstruction of the large statist structures of the past, or rebuilding their unproductive military.

Third, such a depersonalized lending institution could lend to countries that are deemed politically unacceptable to any one member.

Reconstruction efforts in Iraq in the future could be partially financed by such an institution.

I think there will be a certain amount of reconstruction going on in Saudi Arabia and in the rest of the Gulf.

During 1989 and early 1990, there was a renewed sense of optimism among the economic planners in the high-income Gulf Emirates. Policies designed to contain the damage caused by the sharp fall in oil prices in the mid-1980's gave way to new plans to put the oil and nonoil economies on a surer footing.

The Iraqi invasion of Kuwait in late 1990 once again put a halt to these plans as new costs mainly related to financing the multinational war effort were incurred and political uncertainty prompted the private sector to put off a number of investments.

As a result, Gulf governments are likely to pursue three major policy initiatives in the immediate postwar period to try to regain some stability in their economies.

One is they are going to continue the development and expansion of hydrocarbon capacity. The Gulf oil exporters will accelerate plans to increase both Gulf oil and gas capacity.

Second, they will attempt to control government deficits. The Gulf War and the destruction and expenses incurred in its wake will impose a heavy burden on Kuwait and Saudi Arabia in the near future.

Saudi Arabia in 1991 at least will have to continue financing the multinational forces whose presence in the Gulf is likely to be maintained until a clear-cut, postcrisis settlement is reached.

Saudi Arabia also faces large obligations to countries such as Egypt, Syria, Turkey, and Iran for supporting the War.

Third, they are going to have to finance nonoil development.

Since the nonoil private sector in these countries is still largely dependent on government spending, the sharp cutback in capital outlays will be an impediment to economic stability.

In light of this, most Gulf countries will pursue nonbudgetary means to reorient and revive the private sector.

The economic policies outlined above will be pursued in the immediate aftermath of the Gulf crisis. Their purpose is to restore stability.

However, it seems highly unlikely that, with less direct government intervention in the economy, which by implication means a lower level of reliance of the business sector on government largesse, merchants and private businesses will be satisfied with continuing to play a junior partner role to the royal families in the future.

Therefore, if the private sector is called upon to rely upon its resources to finance new investments, it will demand a greater say in the larger economic policy decisionmaking process.

Since this is closely tied to the opening of the whole political process, some elements of the private sector and large merchant families will be allied with the so-called democrats in the Gulf countries.

It will also mark the beginning of the end of what effectively has been the social contract between the rulers and the ruled in the Gulf.

That is, as long as the regime distributed a portion of the oil revenues through government expenditures and provided some national security, they had the fundamental right to exercise primary control over economic policy.

Thank you.

Mr. Wootten. Thank you very much, Fareed.

Now I want to turn to our final panelist for the day, Mr. John Steinbruner.

John has been a Director of Foreign Policy Studies at the Brookings Institution since 1978.

Prior to Brookings, Mr. Steinbruner was an Associate Professor in the School of Organization and Management in the Department of Political Science at Yale University from 1976 to 1978.

From 1973 to 1976, he served as Associate Professor of Public Policy at the John F. Kennedy School of Government at Harvard University where he was also Assistant Director of the Program for Science and International Affairs.

John is a member of the Council on Foreign Relations at the International Institute of Strategic Studies, and the Committee on International Security and Arms Control at the National Academy of Sciences.

John, please proceed.

STATEMENT OF JOHN STEINBRUNER, DIRECTOR OF FOREIGN POLICY STUDIES, THE BROOKINGS INSTITUTION

Mr. **Steinbruner**. Let me begin with a few assertions about the situation.

First, the United States and the International Coalition have inserted themselves into an intense, chronic, highly unstable, regional conflict and really cannot responsibly withdraw without establishing some kind of security. Having disrupted the pot, some constructive recipe will have to be applied.

Second, stable security and order cannot be achieved through the traditional politics of confrontation, by which I mean the traditional balancing of national military establishments arrayed in confrontation with one another.

If you believe both of those things simultaneously, you also have to believe that we are in some trouble because U.S. policy has not developed a regional security conception that goes beyond this balancing of national military establishments. That policy of course is the natural complement and followup to what we have just done, which is to use our military instrument essentially unilaterally. In the wake of that, there is, as I am sure you have all detected, tremendous momentum toward going back to business as usual in dealing with our friends.

If you think that the original propositions are right, then we are in some difficulty in reconceptualizing what we are about, and we probably do not have much time to do it before the old patterns lock themselves in.

This is all a way of saying that winning the peace will be a lot harder than winning the War, much more difficult conceptually, much less rewarding politically, and much less popular.

But I do not believe that we can simply walk away from it.

So what I want to talk about is: OK, if you think all these things, what do we do?

I think everyone who has posed this question recently, including the President, has come up with four basic dimensions or categories in which the answer presumably must be found.

The first is a formalized security arrangement that effectively precludes any seizing of territory by force. We have to somehow establish that that is not possible.

The second is a weapons export control policy that enforces this arrangement and prevents the introduction of weapons of mass destruction. However, they are already there.

Third is a political program to induce some kind of direct, more or less constructive, certainly nonviolent interaction on the part of the political interests in the region, including in particular the Israelis, the Palestinians, and the Islamic fundamentalists.

And the fourth is what we have been discussing: An economic development program that offers some reasonable prospect for overcoming the severe austerity that has beset the large countries, the most populated countries at the present time. This problem will become much worse unless something is done about it.

I think it is reasonable to assume that an answer to the situation involves all four dimensions interacting.

In other words, we will have to put together a policy that integrates these elements—not something that it has been our habit to do.

In my discussion here, I will leave out the latter two dimensions of policy. At least the economic part of it has already been discussed, and I want to concentrate on what the content of the first two would be; that is, a regional security arrangement and a weapons' export control arrangement.

I want to outline an arrangement that would work, using principles that have been, I would say, about half developed. These have to do with changing basic regional security arrangements from a pattern of confrontation to a more cooperative arrangement.

That is more or less what has been going on for some time in Europe—fairly dramatically in the last couple of years. There is a fair amount of logic that has been developed in that regard, and it could in principle be applied in the Middle East. Let me review what the basic elements of such an arrangement would involve.

The key thing is to try to get the states in the region to believe, or to train them to believe, that they are on the same side, that they are not fundamentally in confrontation. The central purpose is to create a security arrangement in which all states participate and none feels excluded from it or confronted.

Doing that requires principles of security that all states can accept for themselves and grant the others.

That means that the purpose of military power must be restricted to the defense of territory currently held and all states must extend to each other respect for their territorial integrity. Security is to be based primarily on these regional understandings with an international guarantee by backing up the arrangement. Basically that is telling everybody: You do not have to defend your own territory all by yourself. The arrangement will prevent any coalition being arrayed against you for offensive reason, and there will be an international guarantee of that principle.

That is fundamentally what we are trying to do in Europe, and we will have to try to do in the Middle East.

In addition, in support of these principles, military forces would have to be defensively configured.

What do we mean by that? Well, it has something to do with their overall size—that is, the amount of fire power that they have. That will have to be, if not exactly equalized, at least balanced in some equitable way.

The arrangement would also have to control the concentration of those forces, their movements, their investment patterns, and the amount of transparency that they provide, and it would have to formalize this enough to provide international support or guarantees of the arrangement.

All that means is one is trying to set military establishments at roughly an equitable size, and trying to prevent any state from concentrating against any other in a way that would enable an offensive operation. The point is to prevent any state from being able to achieve an effective offensive concentration without breaking a lot of rules and without giving sufficient warning time for countermeasures to be undertaken.

One can physically design arrangements of that sort. That is really not the problem. The problem is how you really bring them into effect. There are some fairly significant incentives that might be brought to bear in support of an arrangement of that sort.

If it is achieved, it does produce better security at lower cost, and all states have strong reasons to be interested in that.

It is also plausible, given that most states in the Middle East will have some claim on the international community for developing resources, as you have just been hearing, that a formalized regional security arrangement might be made a condition for access to the international capital markets. That would be a new incentive.

Let me also offer a brief review of weapons export controls, the second element of the overall scheme that would be intended to support cooperative regional arrangements.

Here I think we would have to begin with recognizing that, if weapons of all sorts are to be controlled in the Middle East, then there will be a very different design for weapons' export arrangements globally.

In particular we will have to develop the disclosure principle by setting rules which force everybody to reveal what their weapons programs are and where they are going, as well as their scientific activities particularly in chemical, biological, and nuclear-related areas. Disclosure is necessary if relevant trade flows are to be monitored. Without a rule of disclosure much more developed than we currently have, it is hopeless.

I will expand on that thought, if you want, but, at any rate, I want to emphasize the message. We must develop the principle of disclosure or we are out of business in controlling the most dangerous weapons to this region by means of export controls.

In addition, we clearly must have major supplier cooperation. That is to say, we must bring the Soviets, and the Chinese at least, and probably several others as well, into active cooperation with this kind of arrangement.

I think that is feasible, but obviously it is a big policy enterprise and a big revision of current practice.

Assuming that we design such a global weapons export arrangement and actually bring it about, the regional applications would be quite clearly to formalize a prohibition on weapons of mass destruction, that is chemical, biological, and nuclear weapons. There would also have to be monitoring and enforcement provisions to enforce the prohibition.

It turns out that principal states in the region, including Israel, have already announced in principle that they favor at least a nuclear-free zone for the region.

So a ban on mass destruction weapons can be based on their own proposals. In addition, there will have to be arrangements regulating the scale of all arms sales to the legitimate size of the military establishments. It would not be possible, realistically, to prohibit arms sales to the region absolutely, but they need to be regulated in terms of amounts and types of weapons to correspond to the requirements of defensive missions only and not the projection of power.

Finally, I think in regional applications of both the security regime and the weapons' export control regime there will have to be common management of particularly sensitive functions. This would include particularly the operational monitoring of forces, which is another way of saying national intelligence assets.

Everybody in the region has recognized that one of the decisive advantages that the United States and the International Coalition had in the Persian Gulf War was that we could see and Iraq could not. We had all the intelligence assets. I believe a regional security arrangement constructed in the aftermath of the War should assure that appropriate operation intelligence is acquired through internationally and regionally managed means in order to head off vigorous national competition in this area. All states would be benefited by such an arrangement. They all would receive the operational information that they can legitimately claim to need on a reliable basis internationally supplied and would avoid the expense and risk of attempting to secure this capability through competitive national programs.

In addition to that, I think eventually we will discover the need to manage military air traffic in this region on a common basis so that the use of long-range tactical air assets to conduct pre-preemptive operations is prevented.

These cooperative security provisions are technically feasible, and are not all that hard to design. They may in the long run even be politically compelling. In the short run, I don't have to tell you that it is very hard to predict that this is what will actually happen.

I end with the thought that if we do not develop arrangements of this sort we will be in fairly serious trouble in some period of time. I cannot tell you whether that is 2 years or 5 years, but it is somewhere in that range.

That means we have a lot of thinking to do because we are not ready for policy initiatives of this magnitude.

Mr. WOOTTEN. Thank you, John, for those very thought-provoking words.

I certainly have questions, but I want to give those of you who listened so attentively an opportunity to question our panel.

So I am just going to open it now to questions from the panelists or the audience.

In the back.

RESTRICTING MILITARY POWER AND COLONIALISM

QUESTION FROM AUDIENCE. I had a question for John Steinbruner.

In terms of developing a formal security arrangement, you talk about restricting military power to essentially protect currently held territories.

Does that not inject the old style colonialism? And could that not risk a resurgence of Arab nationalism that in the end would be counterproductive?

Mr. STEINBRUNER. It does basically say that borders cannot be changed by force, whatever you think of the past, either historically, politically, or whatever. Frankly I think we can get away with that proposition.

That principle has been accepted in Africa where the claim against the colonial past is even stronger than it is in the Middle East. The African states have nonetheless accepted the legitimacy of existing borders for fear of the political chaos that otherwise might break out.

The same principle has worked in Europe. It is illegitimate in Europe to claim that borders ought to be changed by force, at least the post-World War II borders, despite the arbitrary shifting of the location of states which occurred as a result of that war.

Against that sort of international background, I think we can say with a straight face that we proposed to apply this standard not just to the Middle East but to the whole world.

Yes, there will be people that do not like it, but I think the principle can be established nonetheless.

Mr. WOOTTEN. John, I have one.

ALLIED COOPERATION IN REGARD TO ARMS SALES

Certainly we all know, from a strictly economic point of view, that arms sales are very, very important to most major countries in the world, to our Allies and our opponents as well. For that reason alone, there has to be an agreement among all of the parties if your plan has any chance of working.

I recall that under President Carter the United States made a unilateral effort to cut back on arms sales and, without the cooperation of our European partners, much less the Soviet block, the experience turned out to be a disaster.

In France, for instance, the third leading industry is foreign arms sales.

This is a long question, John, but what do you think the chances are of getting that kind of Allied cooperation in the Gulf that would be anything near what we had on the direct military mission?

Mr. STEINBRUNER. I admit that this involves extensive revisions of national military policy here, in the Soviet Union, France, and other European countries as well.

There are serene, predictable reductions coming in the financial support of the defense industry in all major countries. It will happen in the United States. It is already happening in the Soviet Union and in France, as well. Weapons producers will have a tendency to try to fend off the implications by imagining a surge in international sales to offset the inevitable large-scale decline in national weapons procurement.

They will be able, under any feasible expansion of arms sales, to achieve their aspirations. But they may try very hard for a period of time, and it may be very difficult to arrange the kind of constraints I am talking about.

In order to do so, it will be necessary to engage the issue of restructuring the national military establishments and the budgets. I do not have to tell you how hard that is. All I can say is that the underlying security and economic incentives to do so are very strong. Over the course of 10 years, this has the aura of inevitability about it.

The question is, will people recognize the imperatives early enough to bring about the simultaneous shift in policy I am talking about? Or will we stumble into it and discover these underlying forces by a lot of sad experience? You would have to bet on the latter. [Laughter.]

But at least it is worth thinking about the former, because all these things are very feasible. They are fundamentally enough in the respective national interests of the major military establishments that somebody who wanted to do it could do it.

I will admit it requires a revision of policy on a scale that we do not see very often, so you have to believe in the circumstances.

Mr. WOOTTEN. One quick follow-on, John.

THE IMPACT OF THE CHANGING SOVIET SITUATION ON ARMS SALES

How has the change in the Soviet situation changed the overall arms sales picture? Or will competition among the different countries take up the slack?

Mr. STEINBRUNER. So far, Soviet policy has been set on a course that is highly compatible. They are trying to reduce and reconfigure their security establishment and get out of the impossible burden of being an opposing alliance all by themselves. This is basically the security policy they are attempting to follow.

They are also attempting, for very good reason, to take some part of their military industrial establishment and apply it for commercial purposes, recognizing that is the core of their technical capability and they must utilize it for broader economic purposes.

I believe the Soviets also recognize that under current conditions they simply cannot compete in critical technical areas, particularly in the sensing and information processing technology that has been so impressively displayed in the Persian Gulf War.

The Soviets are running a decade behind, and falling behind all the more. So unless they connect themselves with the world, and take the heat off themselves in terms of frontal confrontation, they are in deep trouble in terms of their own security.

I think they recognize that. They do want to convert a good part of their industrial establishment to commercial purposes, while subjecting the rest to regulation because they want to regulate us. Cooperating on weapons export sales is a natural element of this policy.

The Soviets have much more reason than we do to worry about the long-term consequences of proliferation. As long as they keep a central government anything like the current one together, I don't think they will be a problem. They will be very responsible.

The problem is much more here and in Europe.

Mr. **Wootten.** Sir, you had a question.

THE TIME FRAME FOR AN ARMS CONTROL AGREEMENT IN THE GULF

Question From Audience. I would like to return to the Middle East for just a minute.

You spoke about this European-like structure that you would like to create there for arms control matters.

If you look, for example, at the conventional forces in the Europe Treaty, the CFE Treaty, which essentially has been fought since 1973, going back that far, if you look at the details of the treaty you have got there is this incredible information exchange, and incredible verification issues.

It has taken the Europeans and the United States more than 20 years to get to that particular point. They will grudgingly submit themselves to this kind of information exchange. How long is this going to take in the Middle East?

Mr. **Steinbruner.** I do not think it will require the same 20 years. It is relevant that that 20-year process has gone on, and the underlying thoughts, if you will, have been developed to the extent that they have. Without those 20 years, there would be no hope whatsoever for a regional security arrangement in the Middle East.

I believe there is a distinct possibility that we could take the underlying principles, not the details of the Treaty, but the underlying principles and apply them in the Middle East using the 20-year investment in developing them that has gone on in Europe.

We can use our very considerable leverage at the moment to bring that about, if we care to do so.

We do have both the conceptual principles and the leverage in this area to do this if we wanted to do it.

The question is: Are we going to want to do it enough?

Mr. **Wootten.** Is "we" in this instance the United States, and not the overall arms sales community?

Mr. **Steinbruner.** The United States in combination with the British, the French, and we would have to bring the Soviets into this, but I do not think there would be any problem.

If there are that many in, I think the Chinese can probably be induced to go along. If we really wanted to do it, we could do it.

THE VERIFICATION AND MONITORING OF ARMS AGREEMENTS IN THE GULF

Question From Audience. My question is for John Steinbruner. It has to do with this question of verification and monitoring and so on.

You presented your scheme for this in a way in which each element seemed to depend on the other element.

I think you explicitly almost said that this was a package; that you had to take all of it, if not most of at, for it to work.

And then you recognized at the end that it is unlikely that such a drastic change will take place.

I wonder, however, whether some pieces of this which are feasible would not, in and of themselves, be helpful in moving us toward this kind of change.

I am thinking of this question of transparency. It seems to me that, in the aftermath of the War, the question of the arms export industries is going to be a much more controversial and salient one than it was prior to that.

We have already seen that with the proposed F–16 sale to Egypt.

Therefore, there will be a certain amount of pressure generated to the extent that these activities are public and are seen.

So my question to you is: Could you see some use in pushing for that particular piece of the package and perhaps building it into a U.N. monitoring system, or some multilateral institutional framework to do the monitoring and the disclosure of these kinds of activities?

Maybe there are other pieces of your package that are similarly by themselves worthwhile to pursue.

Mr. STEINBRUNER. I certainly think the disclosure in the two senses I was talking about is a vital matter and can be separated out from the rest and probably can be meaningfully encouraged by itself. You don't have to have something else to do that. That, by itself, will make a significant difference. So, yes, it can.

Mr. WOOTTEN. Richard, you had a question?

THE CAPITAL DENIAL POLICY AND ACCESS TO MIDDLE EAST OIL

Mr. KAUFMAN. A question for Richard Feinberg.

You have suggested an anti-Marshall Plan in which capital would be withheld so as to induce rethinking and reform.

The Middle Eastern countries may no longer have the Soviet card to play but they still have the oil card to play.

I wonder whether it is realistic for the West, which depends on Middle East oil, to be contemplating a capital denial policy for the Middle East, and whether in the process the West would give up whatever leverage it has to encourage reform in a more positive way?

Mr. FEINBERG. I guess I need to clarify the idea of capital denial. I am not suggesting that we say you are all cut off today definitively until you do these 20 things. You have to do it in a more subtle way on a country-by-country basis.

You look for a certain set of feasible reforms today, and you finance that. Then you take out another set and you do it more gradually. It is just the way it is normally done with other developing countries, et cetera.

Presumably if we are talking about the oil-rich countries, the countries like Saudi Arabia and the Gulf states who will, at least some of them, be borrowing on the private markets. The private markets presumably have learned something about their lending to the Third World in the last 10 to 20 years. It is in their own interests not to lend more than can eventually be paid. They used to think in the 1970's that they could lend and would always be repaid, no matter what happened. The markets have learned that is not the case.

So the private markets vis-a-vis the major oil exporters presumably will be more prudent than they were in lending to other countries.

John Steinbruner of course suggested something that is even more ambitious in the sense that he hinted at that we might use the capital leverage on an across-the-board basis in order to implement regional security arrangements. That perhaps provoke the sort of countermeasure or threat that you are suggesting.

I don't know, you might want to comment on that, but I was doing this more on a country-by-country basis.

PRIVATE INVESTORS AND THE MIDDLE EAST

Mr. **KAUFMAN**. I would like Fareed Mohamedi to comment on the likely attitudes and actions of private investors, and whether they will now be more cautious about investing in the Middle East unless there are assurances of reform, or whether, as the dust of the War settles, it will be business as usual.

Mr. **MOHAMEDI**. Number one, I do not think there has been any reform in the Middle East. In fact, most countries in the Middle East have restricted many foreign investments. So in terms of business as usual, I do not know.

I think, in the future, that is an area that governments should look at, and they should look to long-term development being financed by equity rather than by debt. It will come I think with liberalization and greater democracy in the region.

I just wanted to say one thing about an anti-Marshall Plan. That is, I think, to a certain extent, the Middle East will experience an anti-Marshall Plan in the next 5 years, because of the change in Gulf aid; by that time it will be ready to borrow from a newly established, multilateral institution for economic development which could impose conditionality, et cetera.

Mr. **WOOTTEN**. Senator Proxmire, you had a question?

THE ADMINISTRATION'S POSITION ON ARMS SALES

Senator **PROXMIRE**. I would like to ask Mr. Feinberg and Mr. Mohamedi to comment on what I took to be Mr. Steinbruner's argument that we have a great deal of clout right now in the wake of the victory in the Gulf, and I think perhaps also in the wake of, more important to me in the long run, the great success of the economic sanctions against Iraq we had going for a much longer period.

How realistic is it to expect President Bush, who appears now to be in favor of using the Export-Import Bank to subsidize sales of arms to the Middle East, to reverse what seems to me to be a terrible position and to instead agree to an effort to block the sale of even a bullet to any of these countries in the Middle East, and to do his best to lead an International Coalition against providing them.

Everybody seems to see the logic of not selling arms to the Middle East, yet the Administration seems to be on exactly the other side for some weird reason.

Mr. **FEINBERG**. I think ultimately that your question drives us to one of your own favorite themes, I know; namely, that the basic weakness in overall American foreign policy is derived from our own fiscal failures.

It is the tremendous fiscal deficits and their counterpart deficits in the balance of payments and the trade regime which weaken overall American foreign policy.

And it makes an Administration extremely vulnerable to export interests which will come to them and say, look, we have this huge trade deficit. Here is an opportunity to sell arms. Help us out and move in.

So structurally our ability to carry out a sensible foreign policy is tremendously weakened by our fiscal and trade deficits, sad to say, yes, precisely for the reasons that you and others pointed out in the last decade.

Senator PROXMIRE. I would like to have Mr. Mohamedi comment on that.

I just for the life of me cannot understand, after this heroic, remarkable showing by the President in organizing this Coalition, and now they want to subsidize more arms sales, ending up with arms sales to Iraq.

Mr. WOOTTEN. Fareed, do you want to wade in here?

Mr. MOHAMEDI. Obviously from the point of view of the Middle East it is counterproductive on two levels.

Number one, most governments in the Middle East spent at least 20 percent of their budget expenditures on arms, and on their military, which is another reason you have such unproductive economies.

Then lending money to countries in the Middle East, most of which are heavily indebted, to buy unproductive arms and which don't then lead to exports, et cetera, I think is another reason it is not good economic policy.

Mr. WOOTTEN. John, I think you might want to say something about that.

Mr. STEINBRUNER. Of course it is a stupid situation. The stupidity of it is a symptom of how difficult it is to turn something like this around.

What is driving it is not just the general fiscal deficit of export pressures talked about, but the trajectory of the decline in the defense budget. That is alarming the underlying industry and they are imagining that they can compensate by export sales. The United States does not have a policy position to put these pieces together and balance our overall interests.

The United States will have to restructure the financing of its defense industry at a lower level of expenditure. When we finance our exported weapons sales we do not yet have the planning discipline to relate that process to our own longer term security interests.

QUESTION FROM AUDIENCE. And we had the most spectacular international lesson.

On the one hand we have Russia that is just in terrible economic shape because of their enormous expenditure on the military.

We have on the other hand the two miracle economies of the world, Japan and Germany, which in the last 45 years have gained by getting the hell out of military spending and concentrated their resources where they should, in commerce and industry.

As a result, they are leading the world.

Mr. STEINBRUNER. There is a real point to that. It reflects an imperative to us eventually to go through a major restructuring of the way we do national technical investment.

We have relied too much for too long on the national security rationale, and in a way that is the only way we know how to do it. Although there is an investment at NIH on health. That is a different area of technology.

In investing in the products of the physical sciences—in materials science, telecommunications, computers, and that sort of thing—we have relied on the national security program to provide a political rationale.

It is, as you pointed out, a very poor way to do it in the 1990's and it has not been a very good way since the 1950's, but we have been slow in getting the point.

I think that we do have to go through a major redirection of the way we do this. We will have to support the military establishment in a different way—move support for basic research and weapons development, less for weapons procurement. We will also have to make general economic technical investment using a very different rationale.

People can say that much, but there is no consensus in this country as to how to do it, absolutely none, not a glimmer.

So we are in some trouble on this question. And until we sort this out and have a constructive policy, there will be very powerful tendencies to keep doing it the old way, producing the absurd results you just referred to.

QUESTION FROM AUDIENCE. I just want to follow up on that, with Mr. Mohamedi.

I have two questions.

DEMOCRATIZATION AND INVESTMENT

You seem to imply—I was not sure whether it was a description or a proscription—that an increased role of private investment in the region has to go hand in hand, or create pressure for increased political access by the private sector, particularly in the Gulf states.

I don't know whether you meant "description" or "proscription."

Second, on the whole issue of capital, the use of access to external capital resources as leverage for policy initiatives, I wonder whether the problem of military exports to the region is really symptomatic of a larger problem, which is the desire for commercial exports to the region?

I do not see how you are going to gain a consensus on these other issues such as the capital strike or military control when in fact the State Department—I read cable traffic every day, you know, and every country in the world wants a piece of the Kuwaiti action and will sell their soul to do it.

And certainly it is not just the military. So I guess I have two questions.

One, is there a relationship? Is there really a prospect for democratization concomitant with investment?

And second, are these prospects for multilateral coordination consistent with the kind of intense international competition we see in most of the market spheres?

Mr. **Mohamedi**. The first question is a description of what I was trying to say, that as the budget starts to get tighter and population pressures put economic and political pressures on the government, I think that the governments and the ruling families will compromise with the merchant families.

They will have a limited form of democracy, such as a consultative council.

For example, I think that is a process that Kuwait went through awhile back. I don't think there is any question in my mind that Kuwait is going to have democracy.

It is going to come because the Cabinet could not stand up as currently configured. Most people would not even listen to it.

But I think in the Gulf, the other parts of the Gulf, it will be slower because of economic and political pressures from below. I think the ruling families will compromise with the top elite. So they will slowly open the political process up.

I also think that the merchant families are sick of just playing junior partner and saying, look, we are now going to bring back a lot of the capital that we exported back in the 1970's and the 1980's to reinvest to make these economies dynamic again. And they will want a piece of the political action.

The answer to the second question is, yes.

Mr. **Feinberg**. It is funny.

The country has its own money already, and you do not have to leverage, but we are assuming here a capital shortage for most countries.

Therefore, someone has to grant the loans to drive the exports, and who is going to grant those loans?

Well, private banks are certainly going to be hesitant vis-a-vis most countries.

So we are talking loans from the official sector. Then you do have the leverage, and those loans from the official sector are not going to be as driven as much by commercial interests.

I love this vision of a commercial bourgeois revolution in the Middle East.

Mr. **Mohamedi**. I think it will have to come.

Mr. Feinberg. 18th Century Europe replaying itself in the Middle East.

POLITICAL SENSITIVITY AND ECONOMIC DEVELOPMENT

Question From Audience. Your presentations were interesting. It seems those reforms are being compelled on people, rather than coming from below.

But one of the things you mentioned is politically sensitive and I would like you to expand on that a little bit.

Yes, we have been very politically sensitive in our economic development. We have paid off people. We have bought off the military through large, established military establishments and used them to suppress people. So it is very sensitive economically.

What is your position on that? [Laughter.]

Mr. **Feinberg**. It depends on who is in your coalition.

The very interesting argument being developed here is that there are alternative forces in society on which you could base let's say a more progressive coalition—more progressive in the sense of economic development—a progressive and market aggressive coalition which would be the rise of the merchant class.

These may or may not be a majoritarian focus, but there has to be something there. You cannot implement economic policies in a political vacuum.

But if you could combine at least some coalition with a unified external front, then you could in fact build a coalition which would hold together for a long enough period of time until you begin to get the economic payoff, at which point then you broaden the basis of political support for such a program.

Your comment on my sense that economics is compelling and is not voluntary, that is true anywhere. The drive of market forces is such today that the choices of regimes are limited. It is not just that I am suggesting that we should burden the Middle East with our policy.

I think we in the United States are also largely driven by structural economic forces beyond the control of individual regimes.

Mr. **Wootten**. A question here in front.

Question From Audience. Several economic issues concerning the whole panel.

Arms sales have been competitive.

If we want to turn ourselves into a cooperative affair, there will have to be some negotiations on the profits of the remaining sales. I do not think that is an easy issue.

Concerning the overall costs of social and economic dislocation in the area, it is an uncontrolled issue now. It has also reached far distances outside the area.

We have losses in the Third World which are enormous, and they cannot simply be ignored or pretend that they do not exist.

On the world capital market, we have some very stretched financial situations occurring.

The worthiness of potential borrowers has deteriorated substantially, and we have a banking system which in North America and in the Far East has its own problems where bank liquidity is in question.

So we have a confluence of enormous economic issues which are all relative in terms of a perspective, short-term improvement, or at least a potential improvement to rectify the damage that the crisis has brought.

Any comments? [No response.]

Mr. **Wootten**. I think you have agreement on that one.

Mr. **Kaufman**. I want to ask John Steinbruner about the Israeli factor.

A REGIONAL SECURITY ARRANGEMENT IN LIGHT OF ISRAEL'S MILITARY ADVANTAGE

I did note that you addressed it explicitly, but I wonder how a regional security arrangement of the type that you outlined could be acceptable in light of the present military balance in which

Israel has the advantage, and the likelihood that any regional security arrangement would probably cement that advantage.

I wonder if the other states would go along with that.

Mr. **Steinbruner**. That is an obvious problem.

Just to put some numbers on it, if you took the prewar balances and translated them into something like common units in terms of ground forces, the Iraqis had something like 27, the Israelis 14, the Syrians 10, the Iranians 8. The Iraqis now have probably been cut down below the Israeli standard, and so the Israeli standard stands as the largest force in the region. In addition, they are qualitatively superior. Since the Israeli's have the smallest territory, they also have the densest deployment. That makes it very difficult to balance on the basis of equal density without imposing large cuts on the Israelis, or to balance on the basis of absolute size without granting the Israelis an inherent concentration advantage.

We might try to use the Israeli standard and apply it to the other major states in the region just to see how difficult it would be to get them to go along with it.

Rhetoric aside, they don't have much choice. They will not be able to field larger establishments under prevailing conditions.

So a ceiling set by the size of Israeli forces is not all that binding on them. They cannot do a whole lot about it. If the arrangement included a provision whereby the Israelis believably constrained their nuclear program and eschewed any chemical and biological program, and we had enough time to talk sense to people, I think everybody would recognize it is very much in their interest to agree along these lines, particularly if we were saying that as part of all this there would be some kind of regulation of tactical aircraft operation.

The best argument in favor of this arrangement is the consequence of the alternative. If the states of the Middle East attempt to guarantee their own security by national military programs, they will make matters worse for themselves.

Even for the Israelis the burdens of doing this all by themselves can get to be overwhelming.

Obviously it would be difficult to convince the Israelis, but all of this is hard. I do not think any of it as completely infeasible.

The main thing that threatens the Israelis is long-term proliferation.

They are in deep trouble over 10 or 20 years if we do not get a handle on that, very deep trouble. If the Persian Gulf crisis had occurred 20 years from now when the Iraqis were not such patsies in technical terms, then it would not have been nearly as easy. That is an inevitability, maybe not for the Iraqis, but the Syrians and the Iranians are out there.

So, how do you get people to accept a cooperative security arrangement? Basically, you scare them about the consequences of not accepting it over the long term.

OUR RELATIONSHIP WITH ISRAEL

Question From Audience. What happens if we just recognize the reality that Congress is not going to cut off the Israelis, and the Israelis are our dear friends, and they have earned it.

The Israelis are the only democracy in the Middle East. We say, all right, we are going to make an exception for the Israelis and the hell with everybody else? No weapons of any kind anywhere other than the Israelis? That's it?

What would be the consequences of that policy?

Mr. **STEINBRUNER**. We might follow that kind of policy, but the rest of the world would not.

QUESTION FROM AUDIENCE. You are sure, are you, that the rest of the world wouldn't? Most of the rest of the world that counts are democracies.

Mr. **STEINBRUNER**. I am fairly sure.

You have the Brazilians and the Indians out there also. There is a possibility of fairly significant weapons suppliers, and they will level up technically eventually.

We could get away with that in the short term, and that would be emotionally satisfying to the United States and Israel, but it is unrealistic in the long term. That would be my guess about it.

HALTING CONVENTIONAL ARMS SALES

Mr. **KAUFMAN**. One other question on the arms control suggestion you have made, John.

A recent article in The Washington Post quoted some U.S. officials who suggested that it would be more realistic to control the unconventional types of weapons—that is, nuclear, chemical, biological, and ballistic missiles—than conventional arms.

Given the fact that the oil-producing states will have revenues to buy conventional arms, that there are countries some of whom you mentioned, plus China, who are very willing to transfer conventional arms, how do you react to the idea of concentrating on halting the proliferation of weapons of mass destruction rather than on conventional arms?

Mr. **STEINBRUNER**. Yes. We should focus on halting that proliferation.

But I think the possibility of doing so over extended periods of time is not very great, if you separate the world into favored and disfavored states and do not deal with the broader regime I am talking about.

We should also recognize that probably even more than the weapons of mass destruction, highly conventional accurate arms are very threatening.

They are the major security problem of the future. We just got a glimmer of that in the Persian Gulf War, but that is not the limit of what we are going to have to worry about.

When you can attack a target with essentially zero accuracy error at very long range, and you have the capacity to acquire information about that target, that is in some way an entirely new category of military capability.

It is very, very intrusive and very dangerous. We are on the threshold of such a capability. We are not quite there.

My sense is that if we do not begin to contain that right now, 20 years from now we are going to be in very deep trouble about this.

Therefore, it is those weapons which are mixed in with what we are calling conventional weapons that you really have to worry about, plus the fact the feasibility of controlling over a very long period of time these other weapons of mass destruction is just not very great, unless you induce compliance.

We cannot work the problem with denial for a very long period of time. We must induce compliance.

We have plenty of time with regard to highly sophisticated conventional weapons, but we need the time in order to develop effective controls. So I do not think it is wise to be relaxed about it.

CONCLUSION

Mr. WOOTTEN. On that very ominous note, I know we all have schedules that we want to get on with.

Let me just say in conclusion here that one of the things we try and do here at the CRS is to bring together a broad spectrum of views, competing views, if you will.

That is certainly easy to do when the subject is economics. But I am impressed more today with the high level of agreement among our participants in looking at this very complex problem.

I think what we said today will be very useful to the Members of Congress and their staffs when they return from recess and take up these important issues.

Thank you all very, very much for your attention.

[Whereupon, at 3 p.m., the workshop was adjourned.]

[The following information was supplied for the record:]

(From the Brookings Review, Spring 1991)

The Consequences

FORGING THE NEW WORLD ORDER

John D. Steinbruner

War in the Persian Gulf and disintegration in the Soviet Union have restored a sense of tension to international politics. The exhilaration that burst forth with the liberation of Eastern Europe and the unification of Germany has yielded to concern about economic austerity. The constructive promise of Soviet policy has been darkened by internal ethnic antagonism, by a spiraling decline in economic performance, and by uncompromising behavior at both ends of the political spectrum. The decisive military compaign against Iraq has shattered an instrument of aggression but has not forged enduring political harmony. Given the way it unfolded, the war became a triumphant display of advanced munitions implicitly subordinating the more civilized methods of diplomacy.

Against this background, the new world order, which so recently seemed to be unfolding in a miracle of spontaneous design, suddenly appears to be in severe jeopardy, and the appearance alone helps make it so. Special ridicule and intense disdain are often reserved for those ideas that entice the public's imagination but then disappoint its strongest hopes. This effect is overshadowed in the United States by justifiable pride in an extraordinary military performance, but opinion in the world as a whole is more unsettled. The new world order has been advanced as a justifying purpose for war. It was supposed to prevent it.

But despite the more somber mood, the new era is still forcefully emerging. The Gulf war has not overturned the underlying imperatives that have been transforming international politics. The alliance confrontation in central Europe, which provided the foundation for international security for nearly half a century, continues to dissolve for reasons beyond the sway of recalcitrant bureaucracies. The self-imposed isolation of the centrally planned economies is crumbling under the relentless pressure of international market operations and of irreversible technical change. These fundamental shifts mandate a dramatically revised basis for international politics. Harsh experience makes the task of shaping a new world order less heady now than it was a year ago, but no less necessary.

What Comes Out of Going In

The U.S. involvement in the Persian Gulf conflict will both reinforce the necessity of forging the new order and impose formative experience. Having led an international coalition in one of the world's most virulent endemic conflicts, the United States will undoubtedly be forced in the aftermath to develop new principles of security and to initiate a corresponding redesign of American foreign policy.

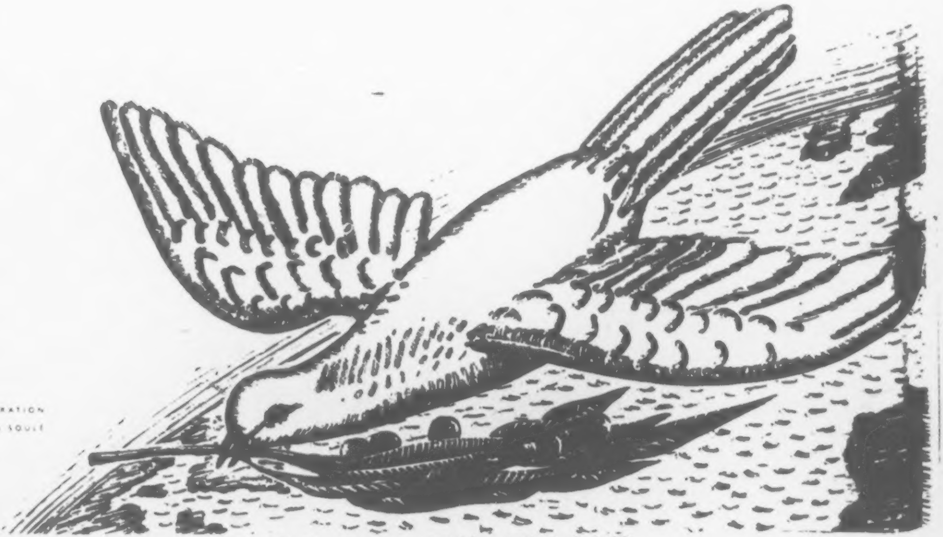

ILLUSTRATION BY BOB SOULE

# of the Gulf War

UNDER A FORCED SCHEDULE

In fact, the formation of the coalition already reflects significant adjustment. Relying on the approval of the United Nations Security Council to justify its action has not been a U.S. habit. Managing the consequences of even the most decisive military victory will make international cooperation yet more vital. Moreover, cooperation will undoubtedly have to be both broadened and systematically developed. Exposed to the highly corrosive effects of radical Arab politics, the initial coalition cannot expect to establish stable security in the region. The U.S. operational role has been too dominant, and the international community has been too incompletely engaged to provide the basis for enduring legitimacy. The crisis is, above all, a battle for legitimacy.

The basic elements of a security arrangement are not difficult to identify. It has become increasingly apparent that security in the Persian Gulf, as in the world more generally, can no longer be accomplished at acceptable cost through the balanced confrontation of national military forces. Nor can the Arab League or some comparable regional organization be expected to achieve a stable result without involving the international community. Given the increasingly dangerous impetus of military technology and its inevitable diffusion throughout the world, cooperative regulation of all the major military establishments has become a practical imperative. Such regulation involves ceilings on force deployments, limitations on military operations, and controls on weapons trade defined in terms that can command agreement across conflicting political perspectives. Security cooperation must be accompanied, moreover, by universally inclusive political and economic policies. It is not feasible to isolate individual states or transnational political movements. Nor is it feasible to sustain a stable security understanding without also offering reasonable prospects for improving economic performance.

These requirements imply a much greater integration of security and of economic policy than has yet been achieved and also a much greater degree of international collaboration. They fall well short of demanding formal international government, but they do require, in a stronger and more specific form, the rule of law

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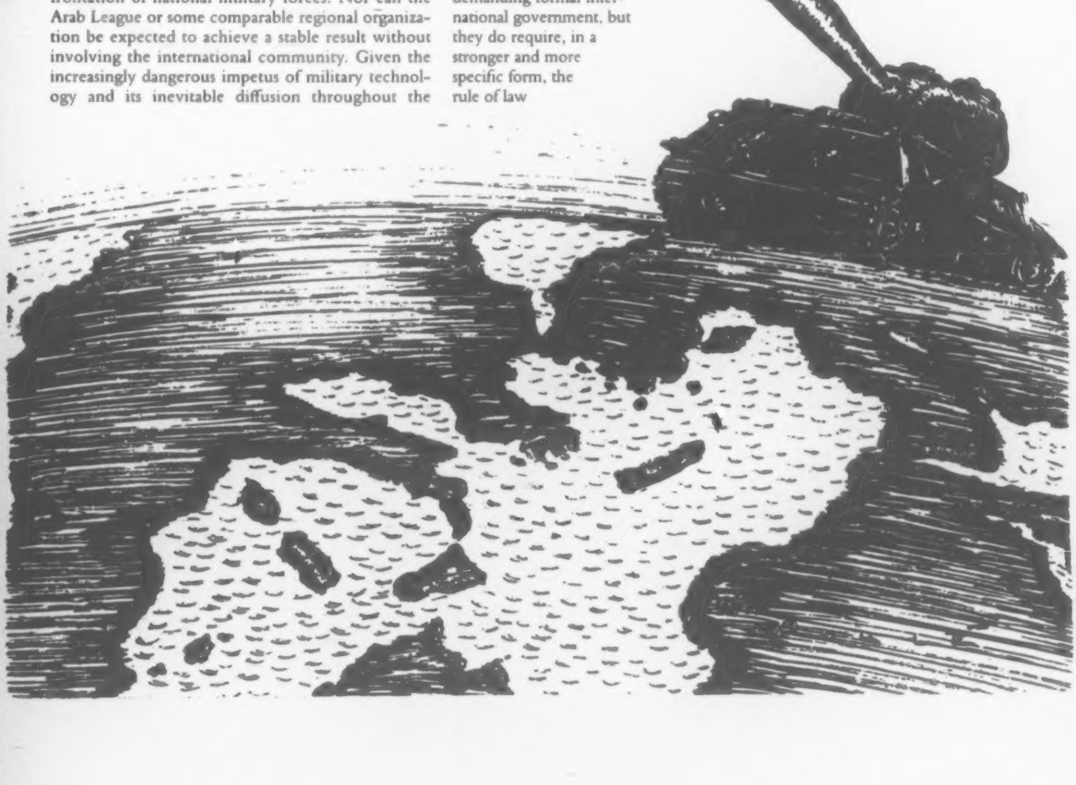

that President Bush has stated as a primary objective.

It is notoriously difficult to give practical meaning to general ideas such as "a new world order" or the "rule of law" or the "integration" of political and economic policy. The U.S. political process has a strong bias for specific decisions and is highly impatient with such conceptual abstractions. It also has had the natural instinct to reinforce immediate success. In the aftermath of victory, the most readily available design for regional security will be legal formalization of the international coalition providing for an indefinite continuation of its presence in Saudi Arabia and Kuwait under U.S. command. Adapted to the more obvious sensitivities of the participating governments, this arrangement might emphasize the positioning of supplies and continuous base access rather than the permanent stationing of forces. But, however judiciously formulated and managed, it would mean a continuing confrontation with Iraq and would leave the status of Israel, Iran, and Jordan troublingly ambiguous for very different reasons. U.N. resolutions cannot elevate such an arrangement to an accepted "rule of law." Nor can they conjure up political appeal within the region.

The chief problem facing the United States following military victory is the limitations and incompleteness of its own policy.

The United States has developed neither a political program nor a regional economic program comparable to the vigorous investment of the past decade that made the mobilization of its military forces possible. It is prudent to assume therefore that the chief problem facing the United States following military victory is the limitations and incompleteness of its own policy. The United States has acquired a commitment that cannot responsibly be restricted to the liberation of Kuwait. Moreover, given the political and economic disruption that the war has caused, the commitment cannot be postponed to a more convenient time. Any applicable designs for regional security, however imperfectly developed, will have to be rapidly adapted to fit the circumstance.

Two designs in particular appear destined to play this role of emergency reinforcement. First, the recently signed agreement for reducing conventional forces in Europe (the CFE agreement) embodies some basic principles of cooperative security that are relevant to the Gulf situation. Second, new perspectives on the control of weapons exports also have potentially important application. The two together do not offer a complete set of policies, but they do promise some of the most urgent components concerning arrangements for guaranteeing the physical security of Kuwait and Saudi Arabia and for regulating regional military forces.

Force Balances

In its specific details, the CFE agreement was overtaken by events before it was signed in November of 1990. The political dissolution of the Warsaw Treaty Organization and the scheduled withdrawal of Soviet forces mooted the major purpose of equalizing the conventional weapons deployments of the two alliances. The new patterns of thinking that produced the treaty, however, also produced a number of principles and shifts in policy that are likely to shape the evolution of European security arrangements. These principles have natural applications to other regions and in fact provide the outline for a global security arrangement. It is a strong presumption that the design of Persian Gulf security following the war should embody the new principles advanced for central Europe.

The key principle is that defense of national territory is the only legitimate purpose of military forces and that they should therefore be configured to resist assault with high confidence but not to project power. The implication is that organized security arrangements should be designed to reinforce this defensive doctrine and to restrict the offensive capability that threatens it.

That general principle is officially accepted by virtually all the European governments. Implementing it is another story. There are two big practical difficulties. First, as a result of their experience in World War II, the major European military establishments have committed themselves to deep interdiction missions and highly mobile ground operations against threatening opponents. The focus of planned attack is not merely or even primarily the lead elements of an opponent's force but rather its organizational capability located well to the rear of the immediate battle area. That strategy was demonstrably effective in the blitzkrieg operations of World War II, and it has the natural appeal that it serves to displace fighting and the damage it causes to the opponent's territory. Second, trends in modern weapons technology encourage this established preference for offensive maneuver. The application of sophisticated sensing and information processing technologies allows extremely accurate navigation over long ranges and the timely identification of targets by remote observation. Both conditions prevailed, of course, in the Persian Gulf conflict. To achieve a defensively configured security arrangement, either in Europe or in the Persian Gulf, requires reversing the operational doctrine of current military organizations and constraining inherent trends in military technology—obviously a tall order.

Four basic methods for solving this problem have been identified, and all four are presumably necessary to establish a robust security arrangement. The first is to equalize the conventional weapons firepower that might be brought to bear in any potential engagement. Organizing an attack designed to seize territory usually requires a superior concentration of force at the point of attack. Ground forces must move to occupy new territory and are thereby denied the protection of fighting from prepared positions. The offensive nearly always suffers a higher casualty rate and thus must compensate by having more firepower assigned to the immediate battle. To the extent that the stock of available firepower is equal, superiority at the point of battle cannot be achieved without suffering inferiority and hence vulnerability somewhere else. Moreover, under conditions of equal firepower, a locally superior concentration of force requires surprise since the defender has the potential to match the concentrations.

The second method of assuring a defensive security arrangement is to require "transparency" of force deployments and movements and thus to deny surprise. If provisions for direct inspection and other opportunities for observation are sufficiently well developed and if the information is shared among cooperating partners, potentially dangerous force concentrations can be detected before they are completed, thereby allowing countermeasures to be taken.

The timing of observation and of countervailing preparation can be made more manageable, moreover, by controlling the density of force deployments and their rate of maneuver—the third and fourth, respectively, of the basic methods. Density refers to the level of forces deployed in a given territory. Even if all potentially opposing forces are equal, it requires attention. If the overall density of forces is high, it is easier both to concentrate offensive forces without being quickly detected and to maintain defensive coverage in areas outside of the point of attack. At lower density of overall deployments, force concentrations are more obvious, and they expose those who risk them to counter-attack elsewhere. At lower densities, however, the relative rate at which potential opponents are able to maneuver becomes more critical as a supplementary method of control.

In Europe the CFE agreement was designed to equalize forces between the two alliances at a relatively high density and was supplemented with extensive provisions for inspections and control of ground force movements. The result was reasonable stability in any potential engagements between the two alliance organizations. The dissolution of the alliance confrontation, however, shows starkly that the national military deployments are not equal and cannot readily be made so because of inherent differences in the size of the states and in their historical investment in military forces. The same inherent imbalance exists in the Persian Gulf region, where its significance is reinforced by more open, less populated terrain that is more suited to offensive maneuvers. Kuwait, for example, could not adopt Switzerland's local defense posture with anything like the same effectiveness. Under the post-alliance circumstances in Europe, therefore, and even more in the Persian Gulf, a defensively configured regional security arrangement requires controls on force density and on relative rate of maneuver supplemented by active enforcement of transparency.

As an illustration of how a standard for ground force density might be determined, one can imagine an agreement defining the troop strength and integral equipment of a basic military unit at levels that might be considered appropriate for defending against attack but deficient for conducting it. Current practices of Middle East armies would suggest a typical standard armored brigade consisting of 40 tanks, 25 artillery pieces, and 55 armored vehicles. Such a unit would have less than half of the tanks and artillery assigned to current brigades designed for offensive operations. If the weapons inventories of the European states were organized into standard defensive brigades of this size, the ceilings imposed by the CFE agreement would allow on average one such brigade for every 50 kilometers of national border area to be defended. The agreements supporting German reunification provided for yet larger reductions in combined German forces. Moreover, the withdrawal of the Soviet army from Eastern Europe, combined with a redirection of internal investment priorities, is expected ultimately to produce smaller Soviet deployments as well. It is a reasonable surmise that the eventual density standard in Europe will be 75 kilometers or more for a standard defensive brigade.

Supplementing the density standard with a geographic grid system to keep local concentrations from departing too drastically from the average standard, while also controlling the rates at which armored brigades are allowed to move (that is, the number of units allowed to redeploy within a given time) and requiring periodic inspection, would provide a reasonably good practical approximation of the basic principles of defensively configured forces. A ground offensive could not be organized without breaking the rules and thereby giving substantial warning. That would not directly force a change in prevailing operational doctrine, but it would put the current emphasis on rapid offensive operations so at odds with declared policy and allowable deployments that an increased emphasis on defensive operations would probably eventually emerge.

Were this design to be applied to the Persian Gulf, the basic standards for average force density and for allowed concentrations at any given point would presumably have to be altered to take into account the very different conditions of terrain, population concentrations, and military history. As reflected in table 1, the armed forces of the Middle East states before the Gulf war varied considerably. Iraq maintained the largest army by far, roughly twice the size of any of the others. Israel, Egypt, and Syria maintained forces that were more comparable in size although less so in assessed quality. Iran approached the size of this second tier, but the militaries of the other regional states were considerably smaller. The table shows the consequences of organizing all these forces into standard defensive brigades and then regulating the number of brigades allowed by applying a common standard of density measured in terms of the land perimeters that each of the countries is required to defend.

These simple numbers illustrate the considerations and fundamental problems that arise in devising a regional security arrangement. If a high density standard (25 kilometers per brigade) were used as the regional criterion, smaller reductions would be imposed on the major establishments, leaving Kuwait, Saudi Arabia, and the Gulf emirates, who happen to be the big economic prizes, well below the regional standard. Presumably an international force would have to be created to bring these states up to the regional standard. Such an international force need not be physically present in its full complement at every moment once the arrangement was in place, but it would have to be able to react within the warning time provided by the inspection arrangement's supplementary controls on force concentrations. With better inspection provisions and stricter controls on movement, the international presence could be smaller. With weaker provisions, it would have to be larger.

Under the lower density standard (100 kilometers per brigade), the reductions imposed on the major military establishments would be more severe, and the disparities to be balanced by an international force would be smaller. Reliance on supplementary measures to control force concentrations and to detect any movement of forces would be greater under the lower density rules.

But however the basic ideas of density, concentration, movement, and transparency might be defined and measured, and however the relationships among them might be balanced, the fundamental point is that a regional arrangement organized along these lines involves a shift in the basis of security. Rather than relying for defense on national military capability supplemented by whatever alliances can be formed, the states of the region would have to rely on the integrity

Table 1: Middle East Ground Force Balances Before the Gulf War

				POSSIBLE DENSITY RULES[1]			
COUNTRY	**Total firepower in standard divisional units[2]**	**Defensive brigades possible with prewar forces[3]**	**Defensive ground perimeter (kilometers)[4]**	**Kilometers per brigade with prewar forces**	**Kilometers per brigade with equal forces[5]**	**Brigades allowed at 25 kilometers per brigade**	**Brigades allowed at 100 kilometers per brigade**
Iraq	27.5	185	2,800	15	31	112	28
Israel	13.3	90	830	9	9	33	8
Egypt	9.8	70	2,200	31	24	88	22
Syria	8.5	79	1,860	23	21	74	19
Iran	6.6	45	3,900	87	43	156	39
Yemen	3.6	30	1,600	53	53	64	16
Saudi Arabia	2.2	22	3,230	149	147	129	32
Jordan	2.0	19	1,730	90	91	69	17
Kuwait	0.9	8	410	55	51	16	4
United Arab Emirates	0.7	7	900	130	129	36	9
Lebanon	–	5	290	53	58	12	3
Oman	–	2	1,300	743	650	52	13
Bahrain	–	2	100	60	50	4	1
Qatar	–	1	100	76	100	4	1

Source: U.S. Army Concepts Analysis Agency, Weapons Effectiveness Indices/Weighted Unit Values III, Study Report CAA-79-12

1. Defensive brigades only. A defensive brigade has 40 tanks, 25 artillery pieces, and 55 armored vehicles, reflective of the weapons ratios currently found in Middle East armies.
2. Armored division equivalent, developed by the U.S. Army, updated and adjusted for the Middle East context.
3. Includes the number of defensive brigades that can be formed from current forces plus defensive brigade equivalents composed of the residual weapons.
4. Considers a relatively smooth-lined military perimeter for defense of national borders, rather than the often twisting borderlines themselves. Coastlines are not counted because of the lack of significant amphibious forces in the region.
5. The ceiling for the five regional powers (Iraq, Israel, Egypt, Syria, Iran) is set at the current Israeli force level.

of the regional arrangement backed by an international guarantee. That guarantee would have to be jointly issued by the major military establishments—at least by the permanent members of the United Nations Security Council—and would presumably have to be based on active participation by a broad coalition of the international community. Within the region, participation in the security arrangement would have to be inclusive. All regional states would become members of the same security organization, and all would actively participate in shaping its rules, enforcing its provisions, and enjoying its major benefit—that is, better security at lower economic cost.

Such an arrangement would give practical definition to an essential part of what is meant by the rule of law. It would define the legitimate bounds of military operations—defense of national territory and only that. It would give operational meaning to the corollary principle that regardless of historical or political logic, borders are not to be changed by military force.

It is evident that the states of the Middle East are not immediately prepared for such an arrangement. As a direct result of the war, Iraq's military forces have been reduced to a level comparable to those of its immediate neighbors Syria and Iran, but in that case would still be superior to those of Jordan and decisively superior to those of Kuwait and Saudi Arabia. By using a common density standard and a balancing international force, a regional arrangement could be created among these states whose basic criteria could be extended fairly readily to Egypt. The smaller Gulf states could be covered with the international force along with Kuwait and Saudi Arabia. It would be exceedingly difficult, however, to incorporate Israel into such an arrangement and equally difficult to leave it as an exception.

Israel stands in stark political confrontation with most of the other states in the region over issues concerning the control of territory. Israeli armed forces exceed those of each of the states with which it shares land boundaries and are generally considered superior in quality. Israel's security policy is fiercely self-reliant, and its operational doctrine in defense of its small land area gives overriding emphasis to preemptive attack beyond its borders against any mobilized threat. Because its land perimeter is much shorter and its total area is much smaller than the other major states, Israel's ground forces could not be adjusted to a common regional standard for force density without imposing highly disproportionate reductions. If, on the other hand, the force sizes are balanced directly among Israel, Syria, Egypt, Iraq, Iran, and perhaps Jordan, then Israel's deployment would have a much higher density, thereby enhancing its already superior offensive capabilities. The basic conditions of ground force deployment revealed in table 1 encourage the impasse that has been endemic to Middle East politics.

The Gulf war was not so appallingly destructive as to break traditional regional attitudes and political antagonisms, as World War II did in Germany and Japan. Nonetheless, the predictable surge of political resentment after the war and the intensified pressure of economic austerity in the highly populated parts of the Middle East are likely to force some meaningful change. No one can confidently predict that a cooperative regional security arrangement will emerge from this caldron, but it is an idea likely to impress itself on those who are compelled to cope with the effects of war on regional politics. And it is worth noting that in the course of extending the design of regional security to other types of weapons, possibilities arise for compensating the inherent imbalance in ground force conditions.

Technology Controls

Cooperative security arrangements defined in terms of ground force concentrations are probably necessary for the new order, but they are certainly not sufficient. Even if the principle of defensive configuration could be perfectly applied to all the world's armies, tactical air and naval operations and weapons of mass destruction would remain, and these are less susceptible to defensive configuration. Although such weapons cannot directly seize and hold territory, they dramatically affect the armies that do. The Persian Gulf war has provided experience on that point that will undoubtedly preoccupy the texts on military doctrine for decades to come.

The fundamental problem with these weapons is that they can operate swiftly and decisively over very long ranges and thereby permit an opponent to collapse a defensively configured force by attacking selected points without having a superior concentration of ground force units. That problem has long been an immediate reality for nuclear weapons. Though we have been spared an actual demonstration, it is evident that a few hundred nuclear weapons delivered with sufficient precision can make it impossible for any military organization to function coherently. Conventional weapons do not yet have such decisive capabilities, but there is reason to be concerned about what they ultimately will be able to do if used preemptively with sufficient surprise. Chemical and biological weapons are inherently less threatening to military organizations but are massively and sensationally so to civilian populations. They open up the possibility of terrorism on a scale that is strategically significant. It seems obvious that the familiar logic of mutual deterrence cannot provide an adequate basis for the rule of law and the new world order as far as these weapons are concerned. Somehow they will have to be effectively discouraged and collectively regulated.

Dealing with the many, well-rehearsed problems of weapons of mass destruction, especially under the forced schedule imposed by the Gulf war, will require observing two practical rules. The first is that a regional security arrangement for the Gulf must be assertively dedicated to preventing any further development there of nuclear, chemical, or biological weapons beyond the ominous but inchoate arsenal that already exists. The second is that cutting off the development of those weapons in the Gulf will be feasible only if drastic restrictions are imposed on existing U.S. and Soviet weapons and probably on those in Europe as well. The development of mass destruction weapons can be halted in the Middle East only if development is halted worldwide. Trying to stop such weapons only in the Gulf—as an exercise in preserving superpower hegemony—is ultimately doomed, a point often made but still not fully grasped outside of the region.

It is helpful that biological weapons are already banned on a global scale and that a treaty to ban chemical weapons is well under way. It is far more difficult to ban nuclear weapons given their much more extensive development and dramatic consequences even in small numbers. Many practical schemes have been devised, however, for large reductions designed to curtail their residual dangers and strategic significance. Progress toward a stable regional security arrangement in the Middle East presumably depends on progress toward one of these schemes. If the integration of political economic and security policy means anything practical, it certainly means that.

With global restrictions on nuclear weapons frequently mentioned as a condition, the basic idea of prohibiting weapons of mass destruction in the Middle East has been officially espoused by several of the principal states. Egypt, not suspected of pursuing its own nuclear weapons program, has advanced a formal proposal to make the region a zone free of all weapons of mass destruction. Israel, which is widely presumed to have a secret arsenal of nuclear weapons but has not directly acknowledged or operationally displayed the weapons, has generally stated its support for the nuclear free zone idea and for a smiliar arrangement for chemical weapons. Iraq, believed to be making intense efforts to develop nuclear weapons, has nonetheless ratified the Non-Proliferation Treaty and has been complying with its inspection requirements. Both Egypt and Iraq have defended the possession of chemical weapons as a deterrent force in lieu of nuclear weapons, but Egypt at least has supported their elimination in connection with a nuclear weapons ban. Again the problem is not so much with the principle, as with the means.

The Gulf war itself will not provide an enduring solution. The attacks on Iraqi installations believed to be associated with nuclear, chemical, and biological weapons activities might retard the underlying programs but will hardly prevent them. For chemicals and biological agents, inherent production capability will quickly be restored as part of economic recovery. Iraqi military capability at any rate depends more on the development of delivery systems than on the production of agents. Varying estimates have been made about the state of the imputed Iraqi nuclear weapons program, but no set of installations has been authoritatively identified whose destruction would absolutely preclude a weapons program. The potential rests substantially on underlying knowledge—not a commodity that can be effectively bombed. The international diffusion of knowledge and of basic technology makes it impossible to deny access to chemical and biological agents and highly problematic to do so for nuclear weapons against a sustained effort to acquire them. Inducing self-restraint will ultimately be the only workable basis for controlling weapons of mass destruction.

It has long been clear that weapons proliferation policy must be substantially redesigned. The current arrangements involve six legally and institutionally separate sets of activities, each focusing on a particular category of weapons: nuclear weapons, chemical agents, biological agents, missile delivery systems, standard conventional munitions, and dual-use technology (technology with both military and commercial uses). One important element is conspicuously missing: no focused efforts have yet developed to control access to advanced conventional munitions, arguably the most significant dimension of future weapons development. Moreover, there is little or no integrated assessment of how the various patterns of weapons proliferation are affecting overall military capability.

Although the methods used and the results achieved by the separate weapons proliferation programs differ substantially, all are designed to deny access to states that are judged, on political grounds, to be unreliable or potentially hostile. That objective was developed under the East-West alliance confrontation and economic isolation characteristic of the Cold War period and reflects its main features. In the post-Cold War period, the basis for categorical political discrimination against certain states is breaking down. Even more important, the internationalization of economic activity is rapidly undermining the ability to deny access to technology. In many critical areas of modern technology, most notably the array of microelectronic technologies that provides the basis for the most sophisticated weapons, commercial markets are driving technical development, and even the most advanced weapons projects are lagging substantially behind. But if basic *access* to technology cannot be prevented, there is a reasonable prospect for regulating the *application* of that technology. The Persian Gulf war might be the catalyst for the impending change.

The outline for a new policy has emerged in the course of a review of export controls on dual-use technology traditionally directed against Eastern Europe and the Soviet Union. Since 1949 the United States and its Western allies have, though the Coordinating Committee on Multilateral Export Controls (generally known as CoCom), regulated the export of a wide variety of technologies and products deemed relevant to weapons application. Through extensive lists of items that require an export license for trade, CoCom has attempted to deny state-of-the-art technology to the members of the Warsaw Pact even though in recent years many of the listed items were available through anonymous market transactions with countries that either were not members of CoCom or only nominally implemented its rules. With these market pressures building in the background, the political revolutions in Eastern Europe, and particularly the unification of Germany, have forced a major liberalization of CoCom export restrictions, the details of which are still being worked out. The liberalization has been conducted so far within the context of traditional policy, at least in the sense that there is an intent to preserve systematic discrimination against the Soviet Union on security grounds. The inherent pressures in the traditional policy, however, have generated active congressional scrutiny, formal outside review, and increasingly vocal resistance from affected industries. This broader process has generated new methods of control and encouraged a new logic of policy with potentially strong implications for the Middle East.

The basic idea is to abandon the increasingly ineffective strategy of controlling dual-use technology by denying it altogether and to require instead disclosure of its end use. Such disclosure would allow the flow of technology to commercial purposes in the Soviet Union and elsewhere while preserving prohibition on military applications. The shift is intended to reinforce economic priorities and to provide a more constructive form of influence over Soviet investment patterns. It is also intended to encourage Soviet cooperation in controlling direct weapons products generally.

An effective regime for controlling weapons proliferation would almost certainly require both the method of disclosure and a policy of cooperation with the Soviet Union (and China). In some areas of technology, notably those involving biological and chemical agents, denial of basic access is so thoroughly infeasible that the only hope of effective control is to establish a general pattern of end-use disclosure and close monitoring arrangements that give some prospect of detecting diversion to weapons application. Unless the major industrial economies collaborate in setting and enforcing these rules, there is little realistic prospect that any dedicated effort can meaningfully control the process of weapons proliferation over the longer term.

The two ingredients for an effective international program—disclosure and general collaboration among the major industrial states—also offer a promising basis for a Middle East security arrangement. In fact, the Gulf crisis may demonstrate so clearly the inadequacies of traditional anti-proliferation policy as to spur development of a workable alternative. Crises, as is often noted, provide opportunity as well as danger. It is doubtful that the United States and its current coalition partners acting separately along traditional lines could have an enduring and decisive effect on the incipient nuclear, chemical, and biological weapons programs in the Gulf in the aftermath of the war. It is nearly as doubtful that they could extend the scope of traditional controls to include accurate long-range conventional munitions. There is far more serious prospect for effective regional controls in the context of a general, collaborative regime that offers positive incentives for commercial application of advanced technology and that integrates controls on the various weapons products.

Again, it is apparent that this element of the new world order is not fully formed in the international community as a whole and is substantially less developed in the Middle East. One cannot confidently expect that redesigned and consolidated weapons proliferation controls will emerge in the aftermath of war as part of a cooperative regional security arrangement for the Middle East. Since it is also unlikely, however, that traditional security practices could be restored, major transformations of this sort will have to be seriously considered and do offer some prospect for accommodating the inherent disparities in ground force capability. If Israel could be induced to develop its own suggestion and to enter an agreement that does effectively prevent the use of mass destruction weapons in the region, then the higher density of its ground force deployments and the operational superiority of its tactical air forces might be tolerated in a cooperative regional arrangement.

What to Conclude?

One searches in vain for easy practical solutions to the many problems urgently posed by the Persian Gulf crisis. Regional security arrangements that would in principle provide a stable outcome require drastic transformations of policy of a sort that rarely occur. The transformations are not infeasible and may even be likely over the long term. At the moment they do stretch the imagination beyond its normal limits. On the other hand, reversion to the traditional politics of confrontation cannot be readily assumed. Though the inertia of existing policies and of prevailing emotions encourages such a thing, the consequences promise to drive political tolerance beyond its normal limits. One can say that it is a compelling moment for statesmanship and hope that someone, somewhere rises to the occasion. One can say also that it is a moment for serious public discussion in the world's democracies. Political leaders, we can be sure, will not rise to the occasion unless they are given some strong encouragement to do so. ■

> The Gulf crisis may demonstrate so clearly the inadequacies of traditional anti-proliferation policy as to spur development of a workable alternative.

MEDIUM TERM IMPLICATIONS OF THE GULF CRISIS

FINANCIAL AND ECONOMIC DEVELOPMENT ISSUES

THE WORLD BANK
WASHINGTON, D.C.

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APRIL 22, 1991

MEDIUM TERM ECONOMIC IMPLICATIONS OF THE GULF CRISIS

It is a great honor and privilege for me to be invited to address this distinguished group, and to be back at the Bank with old friends and colleagues.

My presentation will focus on the economic and financial implications of the Gulf war, and will set that in perspective against the potential roles that international aid agencies can play in the reshaping of the region's economic development. I realize of course that in the presence of this audience, I may be skating on thin ice when discussing the economic issues of the Middle East. I further realize that when it comes to forecasting events in the Middle East, one is more likely to be humbled and proven wrong. That makes it more fun to try.

We all know that the Middle East region is undergoing a highly complex set of changes, whose directions are hard to predict and whose implications are even harder to quantify. Despite its differing manifestations, this change may have been prompted by the same economic and political forces that have prompted the recent changes in Eastern Europe. But unlike dealing with the problems of Eastern Europe, it is my view that the effective way to deal with the economic issues of the Middle East is to view them from a regional perspective. This suggest a model that should be patterned after the post-war European approach, rather than dealing selectively with individual nations based on short-term and parochial political expediencies. The Gulf war is a watershed event in the region's history. Every time the region has experienced such shocks, major ripple effects occurred. The 1956 Suez crisis brought about major political changes in Iraq and Syria a couple of years later. In the aftermath of the 1967 war, change took place in Iraq, Syria, and Libya bringing the current governments into power. More subtle but important changes took place in Egypt and Jordan. The linkages that these historic and political forces have created will very likely be unleashed once again over the coming few years, and are bound to be politically de-stabilizing. That is why I strongly believe in the urgent need of a proactive program to design a coherent economic strategy to help reshape the economies of the region, if stability is to be maintained over the long run.

The theme of this presentation, therefore, is that change: social, political, and economic, will be inevitable and will pervade the entire region over the coming few years. Whether one helps shape this change or reacts to it, depends on the degree of commitment on the part of the international community, and more importantly, the peoples and governments of the region themselves. Because I believe that most of the tangible benefits, however defined, to be gained from the war have already been realized, the ultimate costs are yet to be paid. These costs are difficult to quantify at this stage, but they are likely to be disproportionate to the available resources of the region. That is why the flow of international capital and technical assistance will be critical in the coming few years.

The only major benefit that may yet to be derived from this conflict is to use this opportunity to rebuild a solid base for economic and social policies in the region. That would provide the only real opportunity for regional stability in the long term.

Since this is a "brainstorming session", I shall attempt to describe the possible economic and financial strategies for shaping a new regional economic order. I will focus in particular on the role of international aid agencies and suggest some possible proactive strategies, actually more of a personal wish list, for the World Bank in that regard.

My remarks will be divided into two parts. The first part contains a brief review of present economic and financial implications to the crisis. The second part focusses on the implications for international aid.

II. ECONOMIC & FINANCIAL IMPLICATIONS OF THE CRISIS:

While it is too early to assess the full scope of the economic and financial implications of this crisis, certain economic dimensions may be already evolving. Three such factors are already evident. The first includes the costs: the actual cost of the war itself, the lost opportunities and revenues, and the reconstruction efforts. The second factor involves a potential shift in investment patterns within the region. The third component of change arising from the crisis, is a new set of realignments which have already emerged, where winners and losers can be tentatively identified. In some cases, such winners and losers are easily identifiable. In others, the balance sheet is somewhat murky and the full calculus of costs and benefits are not as readily identifiable.

But, generally, because of the very large cost of the conflict to the participant, and because of the extent and severity of the physical damage, the entire region is a big net loser. In other words, while the pie may have been re-sliced into differing portions, the total size of the pie has been greatly reduced. The only value to identifying economic "winners" and "losers" is to place that in a relative perspective that would aim to consolidate the winners' gains and to cushion and repair the losers' damages over time.

The Losers:

Briefly, Iraq will be the biggest loser economically and politically for the foreseeable future. The heavy damage to the economic and physical infrastructure is estimated at about 70% of the entire country's infrastructure. The high financial debt burden of \$60 to \$80 billion that already existed before the war will bear down heavily on the economy's ability to obtain additional credit. The loss of significant number of the country's young population in the recent crisis and during the war with Iran will limit the country's labor force. Finally, the uncertainty about the country's political future and the issue of reparation will all combine to cast a heavy cloud over its immediate economic prospects. In the longer run, though, Iraq may provide a major engine of economic growth for the region as restructuring of the country's economic and physical infrastructure gets under way.

Kuwait is next in line as a loser in this conflict. But because Kuwait has a large financial cushion, large oil reserves, and a very small population base, the severity of the losses will be less harsh than those in Iraq. The large financial investments that the Kuwait has overseas will probably be reduced, through outright liquidation or through short term borrowings to finance such investments. The problem however is that the Kuwait financial and banking system is strained and serious efforts to consolidate these banks may be needed immediately. Also, the political uncertainty that will prevail over the near term will keep major investment projects from getting underway. More importantly, the conscious decision to limit the guest population will lead to limiting private sector investments in the country for the foreseeable future.

Jordan and Yemen will obviously suffer in two ways. First, financial aid will be less forthcoming from the Gulf oil producers and other international donors. Second, workers remittances from the Gulf will be sharply reduced, and unemployment rates will rise dramatically in these countries.

Saudi Arabia may also be a loser on balance. The cost of the war itself, the heavy financial commitments already made to several countries in the coalition, and the increased military spending will likely keep the country in deficit for the foreseeable future. In 1990, this deficit was over $20 billion, and could conceivably be higher in the next two to three years, depending, in part, on the direction of oil prices. The level of these deficits will also depend on the future commitments for financial assistance to other countries, primarily Egypt and Syria. But it is clear that foreign aid will most likely be more rationed than in the past. Reports are already circulating in the market about potentially large loan syndicates in the international markets to help pay for the country's deficits. The implications of these deficits to the country's domestic economy are difficult to measure, but they depend on the level of public spending. I believe that Saudi Arabia will likely play a greater role in oil politics and production in the coming decade. In this high profile role, there will be an attempt to balance off the desire to maintaining a larger share of oil production and higher income against maintaining stable prices. The outlook appears to be negative for prices in the next two to three years, but by the mid-1990's, global demand will rise to firm up prices again.

The one common thread that runs through the economies of the group of losers is that public sector investments will be the only source of major economic growth in the next few years. The private sector will most likely be disinvesting and flight capital could accelerate. That means that the major economic and financial burden to rebuild the war-damaged infrastructure will have to be born by the public sector and through international aid. This cost, which may be as high as $300 to $500 billion will have to be financed by oil sales, reduction of foreign exchange reserves, and by acquiring new debt. As Kuwaiti and Iraqi oil production capacity is restored, a cycle of competition among oil producers may put a downward pressure on oil prices over the coming two years, at a time of sluggish global demand for energy.

The Winners:

The cliche that there are no real winners in war applies in this case with varying degrees to the countries of the region. To the extent that winners are identified, Syria appears to top the list. Syria will most likely receive substantial financing from the Gulf oil producers and will also have enhanced access to international bi-lateral and multi-lateral credits over the next few years. This should provide a new opportunity to dismantle the existing economic policies and to build a new economic base for the country.

Egypt has also emerged as a winner, although the full impact of such gains is smaller relative to the size of the economy and to the high expectations of big rewards that may have already been built into the system. The major gains for Egypt involve a substantial reduction of the external debt burden, and promises of increased financial aid. There may also be increased opportunities for private capital flows into Egypt and perhaps some other North African countries from Kuwait and Saudi Arabia. This private capital will be small initially, but if properly nurtured, it may become a significant force over the next decade. The net effect of opportunities for Egyptian expatriate workers is not easily identifiable, and may well be neutral. The increased opportunities in the Gulf countries for Egyptian workers to replace Jordanian, Palestinian, and Yemeni labor will be offset against a sizeable reduction of the Egyptian expatriate labor in Iraq, as well as a net reduction in the overall guest work force in the Gulf.

Among the region's non-Arab countries, Iran may also emerge as an economic winner, as enhanced relations with the West and increased influence within the region will boost economic opportunities and confidence in the country. The medium term economic impacts of the Gulf crisis on Turkey is probably the most difficult to assess. The short term impacts have so far been obviously negative. But there are serious opportunities for enhanced trade and private sector investments. Despite many of its shortcomings, the Turkish experiment in the past decade with economic reform and with external debt management may well serve as a model for the region's economic management. At least, the economic managers of the region could learn from the successes and failures of a daring experiment in an economic and social setting that is not too dissimilar to theirs. That may also form the basis for increased economic linkages with the region.

III. THE ROLE OF INTERNATIONAL AID

There are, in my view two key impacts that the current crisis may have on formulating international aid strategies to the Middle East. The first is the dramatically increased level of financial resources that would have to be channelled into the region. The second impact is on the structure of this aid, where there will be a need to combine lending and foreign direct investments with higher levels of technical assistance. That would, in effect, create a closer partnership between the international aid agencies and the recipients. Also, the crisis itself may provide a unique opportunity to design coherent regional economic and investment strategies that would generate synergies and strengthen economic and financial linkages among the economies of the region the outside world.

I shall briefly address these issues and suggest a possible strategy, more of a personal wish list, for the World Bank in this regard.

III.a. Level of Economic Assistance:

Not only is the physical and economic damage to the region is devastating by any historic standards, the crisis itself has shifted the focus on the economic disparities of the region and raised expectations about dealing with such disparities. It would therefore be reasonable that a sharply increased aid flow to deal with the festering problems of the region. This will be particularly difficult against a backdrop of rising capital needs in Eastern Europe and the Soviet Union, rising deficits in the U.S. and Germany, reduced liquidity and desire to lend overseas among the OECD commercial banks, and shrinking foreign aid budgets. The burden for meeting the region's increased need for foreign assistance will fall initially on the World Bank and the international aid community. It is questionable whether these institutions can provide substantial sid to the region out of their ongoing lending program. Consequently, special vehicles need to be structured and separately funded for this purpose. There is absolutely no need to create a new bank or fund for this purpose, as was done, unnecessarily in my view, in the case of the European Bank for Reconstruction and Development. Instead, a separately funded facility operated by the World Bank can easily do the job. There are many advantages for such a facility to be operated by the World Bank and its affiliates. First, it can draw upon the vast experience and institutional memory of the Bank and its affiliates, primarily IFC and MIGA, in shaping new policies and lending programs. Second, there will be no new costly bureaucracy, duplication of efforts, and political agendas inherent in new institutions. Third, the Bank can augment the new facility by the traditional lending out of its existing program. Finally, the Bank can use its existing infrastructure and network with other multi-lateral and bilateral agencies, as well as the private sector to channel aid through programs it helped shape and coordinate.

III.b. Structure of Foreign Assistance:

No amount of aid will have a lasting effect on the region's economy unless it is coupled with major policy reforms that ultimately aim at reducing the role of the public sector and encouraging repatriation of flight capital and attracting foreign investments. The success of foreign aid programs can only be measured by how quickly the borrowers graduate, to use a World Bank terminology, and not by how much they borrow. The failure to graduate in a timely fashion reflects equally negatively on the students as well as on the teachers.

To the extent that there is an economic "silver lining", the Gulf crisis could provide a unique opportunity for a fresh and creative initiative to restructure the region's economies. That restructuring will involve the design of policies to speed up efforts to enhance the private sector role and repatriate flight capital that has been leaving the region at supersonic speeds.

Also, programs that help reduce external debt, such as debt for equity swaps and similar mechanisms should be explored. IFC can help promote country funds and venture capital that raise venture capital abroad and invest it in new and privatized domestic enterprise. The World Bank and IFC can also help foster the development of an efficient financial infrastructure in the region. In that enormous efforts are needed to develop appropriate regulatory frameworks and internationally acceptable accounting standards to help promote private investments and encourage capital flows into the region. Without a well functioning banking system and a working capital market, it would be difficult to provide capital for the private sector by harnessing and channeling the national savings into productive investments. MIGA can help design aggressive programs to deal with political and other non-commercial risks. In this manner, both public and private capital can be encouraged to flow into these economies with the confidence that the new policies will generate reasonable growth and economic returns that are commensurate with the high risks involved.

Finally, the international aid community may be able to shape a regional economic strategy that will serve to strengthen economic and financial ties within the region. Such a strategy may take advantage of the comparative advantages in differing parts of the region to create synergies that would avoid duplication of investments. This regional focus will have several advantages, at times of capital scarcity, including the creation of employment opportunities for the displaced work force in the Gulf countries.

IV. A PROPOSED INTERNATIONAL AID STRATEGY:

I believe that this crisis provides a unique opportunity to help shape a sound basis for longer run economic growth for the region. I also believe that the window of opportunity is rather small and unless utilized quickly and decisively, it may not be open very long. To this end, I would like to propose some course of action, which is more like a personal wish list. I call this a wish list because I am mindful of the diminishing availability of foreign aid, and against a backdrop of capital scarcity, rising competition for scarce capital, and reluctance to lend by the commercial banks. I also call it a wish list because one cannot be sanguine about enormity of the task involved, and about the political will in the donor countries and in the region to make such wishes come true. Nevertheless, my wish list include the following:

1. I wish that the World Bank, perhaps jointly with the IMF, would undertake to sponsor a special $100 billion fund for the Middle East, to be administered separately from the Bank's ongoing lending activity over the next ten years. The fund would be capitalized by joint contributions from the Bank's own resources, as well as from the industrial nations and from the Arab oil producers. The proceeds of this fund will be used for reconstruction efforts and in support of coherent domestic and regionally focussed economic policies.

2. I wish that the World Bank and the IMF would establish a joint major regional office to be staffed with one to two hundred professionals. The staff will have the primary responsibility for designing and supervising the entire lending and technical assistance efforts for the region. The presence of such professionals "on the ground" is important not only to underscore the depth and extent of international commitment, but is also important to shape realistic programs and help monitor their progress. The Bank staff should focus on providing major technical assistance to all countries in the region, including inputs to major policy decisions of the oil producing countries.

3. I wish that the World Bank will work with the multitude of regional and bilateral aid agencies of the region, as well as with others outside the region to coordinate the region's aid activities. The object will be to ensure that ultimately all of the aid flow into the region will be in support of the Bank's designed programs. In other words, the World Bank will act as the super-administrator of aid into, and within, the region.

4. I wish that all the regional development institutions combine their resources into one that coordinates closely with the World Bank. Working separately, these regional aid agencies are too small, too fragmented, and too weak politically to deliver effective aid packages to the region at this point. The Arab Fund could, in effect, become a super-regional aid agency, combining the staff and resources of the others.

5. I wish that IFC would sponsor a $5 billion fund to invest in the region. The fund can attract capital from private venture capital groups, from corporations that aspire to participate in the reconstruction boom, from commercial banks that prefer to work under the IFC umbrella, and from governmental and public entities.

6. I wish that IFC would set a large regional office in the region with the object of working to foster the developments of viable financial systems, functioning stock exchanges, and to support the region's privatization of public enterprises.

7. I wish that MIGA would devote a special attention to provide non-commercial risk protection to investors who may otherwise be concerned about such risk. In that, MIGA can work with similar regional and bi-lateral groups to stimulate the flow of private capital into the region.

8. Finally, and most importantly, I wish that the countries of the region, particularly large ones such as Egypt and eventually Iraq, would bite the bullet and adopt the type of policy reforms that would encourage their own citizens to invest in the future of the region. If the people of the region invest overseas, how could the governments expect outsiders to invest their capital. If Egyptian citizens alone were to repatriate their investments of over $40 billion abroad, the country would be debt-free.

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